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The JOURNAL of ACCOUNTANCY

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A. P. RICHARDSON, *Editor*

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EDITORIAL

The Insull Case

With dramatic suddenness the first chapter of the celebrated case against Samuel Insull and others came to an end, as the jury after two hours' deliberation brought in a verdict of not guilty. The specific charge under which this first case proceeded was one of conspiracy and using the mails to defraud. There are many interesting lessons to be learned from the case and one of them, at least, is of the utmost importance to professional accountants. In general the verdict of not guilty seems to indicate that the jury may have been swayed by two major considerations, in addition to that which has been openly reported. It is said that the verdict was largely attributable to the appealing defense presented by the chief defendant, but it seems to us that other equally cogent reasons induced the jury to reach its conclusion with such astonishing rapidity. In the first place, it seems that the government through its very able prosecutors overbid its hand and, in alleging conspiracy from the inception of the Insull companies, went far beyond all reasonable bounds and thereby weakened the entire argument against the defendants. We are not concerned at the moment with the moral responsibility for the collapse of the great group of public-utility companies with which the name of Insull has been inseparably associated. Probably it is safe to say that what was done in that case did not differ greatly from what was done in countless other cases. Reprehensible as much of the conduct of the companies may have been, there would certainly have been no hue and cry of ven-

geance had the prosperity of the companies not been destroyed by the collapse of values in 1929. We do not mean to express approval of what was done, but merely in fairness to all to point out that it was failure which discovered bad practice. No inherent badness of the practice itself led to attack upon it.

**Sympathy with the
Under Dog**

The second general consideration which must have impressed itself upon the jurors was the position which all corporations great and small, good and bad, now occupy in our current scheme of destructive reformation. There have been so much tumult and shouting, so much misrepresentation and so much lying about business, that people are becoming a little weary of the campaign of calumny. Heaven knows there has been enough unworthy custom in the transaction of business, but that is not to admit that everything with which the words corporation and company are remotely concerned must of itself be wholly evil. The ordinary man is a reasonable creature and is not to be deceived forever by loud words oft repeated. Here in America we like to think that the ordinary man is also a champion of the under dog. And so it seems that as the chase quickened and every form of profit-seeking activity became a quarry, the spectators tired of the pastime and began to wonder if perhaps there might not still be some little goodness hidden away somewhere under the skin of American business. From such a vague surmise there has grown more and more impatience with outrageous prosecution of business merely because it was business. Therefore, while the jurors may not have mentioned the matter in the jury room, it seems just to suppose that in the mind of each one of them there may have been, perhaps subconsciously, a feeling of distaste and a willingness to give business a chance to carry on.

**Treatment of Stock
Dividends**

The point which is of peculiar and enduring interest to accountants in the whole Insull case is, however, one of technique. The case dealt largely with the pyramiding of investments and the inter-company payment of stock dividends, which were taken into the respective accounts at the market prices on the dates of declaration. The government sought to prove, and perhaps succeeded, that the market was artificially

stimulated, and that therefore market prices for a share of stock were not indicative of any lasting value. But here again, we think, the government may have missed the vital factor. Whether the market were "rigged" or not, it was not good accounting practice to enter among the assets of any company stock dividends which were retained in the portfolio of the recipient. Probably ninety-five per cent. of practising accountants agree with the decision of the supreme court of the United States in the case of *Eisner versus Macomber*. Even accountants who may have felt that there was good logic in the theory that a receipt which could be sold for cash might be regarded as income have now for the most part changed their opinions and are in favor of taking nothing as income which does not represent a closed transaction. Admitting all this there is, however, another side of the question which has been too much ignored.

A Dissenting Opinion Recalled To refresh the memory of readers, let us recall that the act of 1916 treated a stock dividend as income "to the amount of its cash value" and that the decision in *Eisner versus Macomber* was not a unanimous finding of the supreme court but was the subject of dissent by four justices, the maximum possible minority in a court of nine. The dissenting justices were Brandeis, Clarke, Holmes and Day, all of them men whose opinion is worthy of respect. These dissenting justices held that the 16th amendment to the constitution entitled congress to assume "in a sense most obvious to the common understanding at the time of its adoption" that the tax upon stock dividends as income was justified by the amendment. Justice Brandeis, with the concurrence of Justice Clarke, concluded his dissenting opinion in part as follows:

"If stock dividends representing profits are held exempt from taxation under the 16th amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends they will pay these taxes not upon their income but only upon their income of their income. That such a result was intended by the people of the United States when adopting the 16th amendment is inconceivable. Our sole duty is to ascertain their intent as therein expressed. In terse comprehensive language befitting the constitution

they empowered congress, 'to lay and collect taxes on incomes from whatever source derived.' They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded not only by the plain people but by investors and financiers, and by most of the courts of the country, is shown beyond peradventure by their acts and by their utterances. It seems to me clear, therefore, that congress possesses the power which it exercised to make dividends, representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the 16th amendment."

**An Excuse but Not
Justification**

We find, therefore, that congress in its interpretation of the 16th amendment felt that it had a right to levy a tax upon stock dividends as income and that four justices of the supreme court agreed with congress that the taxation of stock dividends under the revenue act of September 8, 1916, was in conformity with the purposes of the so-called income-tax amendment. In view of these facts, it seems somewhat fantastic to attempt to classify as a crime the treatment of stock dividends as income to a corporation. As we have said, from the point of view of the accountant, there is nothing to be said in favor of the treatment adopted. It violates the principles of technique and sound economy; but those corporation officers and advisors who may have been induced to approve or at least to tolerate the inclusion of stock dividends as income can not fairly be accused of crime for doing what congress and the maximum minority of the supreme court held to be right. The most serious charge that could be laid at the door of those who favored such a classification of stock dividends would be an allegation of bad judgment and of lack of scientific knowledge. Had there been no act of congress supporting the theory of stock dividends as income, and had there been no minority dissenting in the supreme court when the case was under consideration, it might be possible to justify an accusation of criminal intent, but surely there can be no justice in imputing a crime to an individual officer who does what the majority of congress and a powerful minority of the highest court authorized. We believe, therefore, that the charge against Insull and his co-defendants, at least so far as the treatment of stock dividends was

concerned, was not supportable in law or reason, and it is satisfactory to know that a jury of twelve ordinary citizens threw out of court the charges which depended largely upon this one question of the classification of stock dividends.

**Probable Effects of
Decision**

What we have written with reference to the inequity of the charges against the defendants in the Insull case is based upon the principles of fair play, and we trust that it will not be construed as any attempt to approve the practice which was followed by the Insull corporations. In other words, to take into the accounts stock dividends as income was not a crime, but it was certainly bad accounting practice. The tragic break in market values of all securities demonstrated incontestably the fallacy of the theory upon which a stock dividend may be taken into the accounts as income. It may have no value whatever. Perhaps one of the few good results of the depression will be the final settlement of this controversial question. It is certain that the unwisdom of regarding a split-up of stock as productive of profit must have been finally demonstrated with the experiences of the last five years. Most accountants have long understood the true nature of stock dividends and have insisted that their clients regard them in their true light. At times there have been acrimonious differences between accountants and clients on this subject, and many officers of companies have felt that the accountants were needlessly scrupulous. What has happened in the Insull case, and in many others as well, will hereafter afford a sufficient argument against the misuse of stock dividends in financial statements, and the position of the accountant will be stronger than ever. In a word, then, we rejoice that the allegation of crime so far as it was supposed to lie in the mishandling of stock dividends was repudiated, and we rejoice even more that the accounting profession will be upheld in its attempt to raise to the highest level the accuracy and intelligibility of accounts.

**Arbitrary Reduction of
Fees**

The daily papers of November 15th contained reports of certain recommendations filed by the referee in bankruptcy in the Paramount-Publix bankruptcy proceedings. The referee recommended that allowances aggregating \$362,580

be made to lawyers and accountants for services rendered during the period beginning June, 1933, when the Paramount-Publix corporation was in the hands of equity receivers. The referee, sitting as a special master, had received petitions for allowances totalling \$720,000. These were reduced by his recommendations on the average about one half. We are particularly interested in the recommendations of the referee relative to the claims of accountants. In one case a fee of \$21,870 was reduced to \$10,000, and various smaller fees were cut in like proportion. These substantial reductions in fees were not apparently based upon any theory that the services of lawyers and accountants had been unsatisfactory. Indeed, the referee specifically stated that trustees, lawyers and accountants had devoted "long and careful attention" to the bankruptcy. Of course, the recommendations of the referee are not necessarily final, as to be effective they must be approved by the United States district court; but a highly important question is raised by this attempt to reduce fees of professional men. It seems that the lawyers and accountants in this case are not on exactly the same footing. It is understood that in this sort of work the fees for accounting service often are arranged in advance and the work is undertaken on the understanding that the fees will be paid in full. It seems, therefore, that there can be no excuse for an arbitrary breach of what is, in effect, a contract. If it had been alleged in the Paramount case that the fees were exorbitant, there might be some justification of an effort to obtain consent to a reduction; but apparently there was no thought of anything of the kind until the matter came before the referee. The duty of a referee in bankruptcy, as we see it, is to protect in every proper way the bankrupt concern and its creditors. There is an equal duty to both parties. We fail to understand, therefore, how the referee could advocate a sacrifice of the interests of the professional men who were creditors. As a matter of fact, the actual prime cost of the services rendered by accountants must have been much more than the amount recommended by the referee. It is rare, in the experience of accountants, to receive a fee double the amount of salaries and overhead; consequently the recommendation of the referee in this case, if approved, would involve an actual out-of-pocket loss to the accountants. There is no reason whatever why they should be expected to participate in the losses of the company. Every one knows that lawyers and other professional

men often demand fees which seem ridiculously high, but, of all the professions, accountancy is the one whose fees generally speaking are based upon actual cost with only a modest allowance for profit. There is all the less justice, therefore, in an arbitrary and destructive recommendation that fees be halved.

The Problem of Seasonal Business The financial statement of General Motors Corporation dated September, 1934, and distributed to stock-holders contained a letter from the president, Alfred P. Sloane, which will be read with close attention by accountants. Speaking of the seasonal character of the automobile business, Mr. Sloane said:

“The automotive industry, in common with many other industries, has a highly seasonal consumer demand. Normally, approximately 60% of the industry's yearly output is sold to the consumer in the first six months. Consumer sales in the two months of November and December are approximately 7.5% of the total for the year, as against 24% for the two months of April and May. Such an unbalanced situation throws a burden upon the whole production machine. Additional workers are required for the period of the peak season, with but limited opportunity for employment during the balance of the year. Longer hours are essential for the whole working force in the peak season, to offset the necessity of short hours in the season when the merchandise can not be sold except in greatly reduced quantity. This general situation has been intensified to the detriment of the wage earner and to the national economy in general by the code restrictions incident to the program of national recovery.

“While it is recognized that the ‘selling of straw hats in the winter time’ is bound to be of limited success, under any circumstances or conditions, nevertheless, the corporation is determined to do what it can in the spirit of helpfulness and coöperation, in the interest of its workers, whom it recognizes as vital contributors to the success of its business.”

Common Interests of Business and Accountancy Here is another striking commentary upon the difficulties encountered by all businesses which are affected by the rotation of the seasons. Accountants for many years have been advocating that business adopt its natural fiscal year; and at times there has been a disposition on the part of legislators and some business men to regard the efforts

of accountants to spread their work over the whole year as merely an evidence of accountants' desire to make their own work easier. But this is one of the many matters in which the interests of accountants and of the business public are concurrent. Mr. Sloane, speaking for one of the greatest corporations in the world, not only deplores the difficulties arising from the seasonal character of his industry but also indicates the precise nature of the difficulties. When he says that the automotive industry by its seasonal nature leads to "detriment to the wage earner and to national economy," he is speaking of a purely specific condition. He might well have added that concentration of work in a portion of the year is a detriment also to every one who is brought in touch with the industry. While Mr. Sloane believes that attempts to spread the work of the industry over the entire year may be of limited success, it is undoubtedly true that an earnest and consistent effort to avoid unnecessary concentration of work will bear substantial fruit. The automotive industry is one which presents a splendid opportunity for an experiment in the equalization of labor. The natural business year of that industry is probably one that ends with June 30th, and if General Motors Corporation will arrange its financial schedule to close its books at that date the advantages of this change will be manifest to the other great manufacturers and they in turn will probably follow. The automotive industry is doubtless here to stay and it will constitute an increasingly important part in the work of accountants, income-tax authorities and others. There seems to be no reason at all why this industry should not close its books at a time when stocks are lowest; yet few of the large companies have seen the wisdom of adopting their natural year. Now, with the testimony of the head of the largest automobile company in the world to support the movement for the adoption of the natural business year, a little extra effort upon the part of accountants and others should induce the change from an artificial and troublesome calendar-year closing. Every one concerned would benefit by the change and no one would suffer any inconvenience.

**Toward the Perfect
Day**

A few months ago a correspondent sent us information about a scheme which had been promulgated in California for the general amelioration of the condition of mankind and the bringing in of the kingdom of Utopia. It struck us at the time as

an essay in the humor of benevolence. It did not seem then—and does not seem now—as though any ordinarily intelligent citizen of the republic could regard seriously so wild and impracticable a proposition. But lately there has been a coördinated effort in nearly every part of the country to obtain endorsement of this extraordinary plan. It originated in the kindly mind of Dr. F. E. Townsend, who, thinking no doubt of the many unfortunate people whom he had encountered, devised a revolutionary theory which, its proponents are saying, would usher in the dawn of the perfect day. In brief, the scheme calls for a federal pension of \$200 a month to every citizen attaining the age of sixty years, whose record so far as crime is concerned is clear. In return for this comfortable livelihood the recipient is to agree to abstain from all gainful occupation and to spend within the confines of the United States the entire \$200 within thirty days of its receipt. It is estimated on the authority of “statisticians” that the initial cost for the first month of operation would be approximately two billion dollars, which is to be provided by act of congress. Thereafter the expenditure of the two billion of monthly income to the aged will so encourage business and stimulate activity that the thing will become self-supporting. The exact process by which two billion dollars expended in September will so quickly revert to the government as to provide the two billion dollars required for October is not clearly shown. It is said that a sales tax of two per cent. will produce the amount required, but we have yet to find upon what basis this computation rests. It seems to imply an immediate return to the government as a result of a sales tax and thus to establish a sort of revolving fund which will take care of the disbursements of the months as they occur in the march of time.

**Almost Anything
Might Happen**

The arch proponent of the Townsend plan expresses the belief that ninety per cent. of the voters of the country would favor adoption of such a measure. Probably ninety per cent. would approve. Approximately ninety per cent. would not be able to see sufficiently far or clearly to understand the utter disaster which would follow so preposterous an overthrow of the fundamentals of economics. It seems to us that those who advocate and those who support such a plan are setting cheerily out on a road, not clearly defined on either side, but leading, they

blindly trust, over the mountains to that undiscovered land where the cattle always have longer horns. And it has been said of the people of these United States that they are lacking in imagination! If it were not for the extraordinary response which has met this call from fairyland it would still be merely a subject of gracious entertainment. But there is apparently some danger that it may go beyond the realm of idle speculation and find its way into that morass of brainless legislation which takes up so great a part of the time of congress. If ninety per cent. of the voters favor such a plan we may be quite sure that there will be members of congress who will not dare to oppose it. (There have been cases in the history of this country in which legislators have sometimes demonstrated a little less than divine wisdom.) It is even conceivable in the present state of the public mentality that the thing might become a law. Of course it could not be administered, but the impossibility of administration has not always checked the enactment of perfectly futile legislation. We have, however, a supreme faith in the ultimate good sense of the American people, and if by chance or by opaqueness the Townsend measure should become a law it would soon be rescinded. But in the meantime much grievous damage might be wrought.

**The Land of Corn
and Wine**

On the other hand, what glorious vistas are opened before us. Two hundred dollars a month is more than most of us have ever received, and we shall be a little bit confused by our sudden accession of wealth. We are to spend our money promptly, and in order that we may be kept strictly in the narrow path it will be necessary for some child under sixty to follow us around throughout the month and see that we spend. This, of course, will entirely abolish the evils of unemployment. Then, again, if we strike out all sexagenarians, we shall be relieved of the presence in active life of many of the members of congress, quite a host of senators and a vast number of the men who are now directing the affairs of American business, as it is still called. There will be great demand for some of the things which we now regard as luxuries—for example, fine white pine and sharp pocket knives will be urgently needed to occupy the idle time of the aged brethren on the steps of the country store; but they must be careful never to sell or to give away with any thought of ultimate recompense a toy boat or a duck's head in which the whittling

fever may have taken form. Again, we have been disappointed in the revenues derived from the sale of liquor. For two hundred dollars a month, which must be spent, each of us will be able to buy a fair amount of stimulant, even at the present prices. Another blessing will soon appear to all who long for rest or for a pension. Everyone with even a little political influence will be able to set the clock ahead by ten or twenty years and then we shall take up polo and badminton, suitable to the prematurely aged. Of course, some of us, as we reach the end of the world on the sixtieth degree of west longitude, may feel a little regret at leaving behind us all the things for which we have striven, but we shall soon become used to the sweet spaces of do-nothingness, and at last we shall learn to sit and fold our hands and care nothing at all whether the country goes to hell or not, so long as we may remain within the passive realm. There is, however, one speck in the clear blue sky of this Utopia: really \$200 is not very much money, and we do not see why it should not be \$2,000 a month or some greater sum, because, if a mere \$200 for each of us over the hill will bring in the promised day, why not apply the same principle and give us more, to the end that prosperity may the more increase. That, when one comes to think of it, is a rather serious oversight in the drafting of the plan. Let us set no limit upon what the old fellows are to receive. They may learn easily to spend and for every dollar they spend let us think how the rest of the country will advance, and let us be glad proportionately.

Education for Professional Accountants*

BY WARREN W. NISSLEY

The subject assigned to me for discussion is so broad that it can not, of course, be covered in one evening. Since no particular divisions of it were designated when I was asked to talk to you, you must expect to hear about those in which I am most interested.

At the start let me say that I am not now, and never have been, associated in any way with any educational institutions other than those I attended myself and my association with those was limited to the periods of my attendance. I have had no experience in imparting formal accountancy education or any other form of education to students. While I shall discuss some features of formal educational technique in general terms, my remarks will be based on the impressions as to the present status and future needs of accountancy education that I have received as an accountancy practitioner and in my relationships with fellow practitioners and on my experiences while serving as chairman of the Institute's committee for placements and of the New York State Society's committee on education, and not on any experience as an educator.

There are many complaints nowadays that it is difficult to determine just what measures are being advocated after one has listened to a speech by a public official. While I am not a public official, I will state my platform in the beginning, to avoid that complaint here.

I am an advocate of requiring in the near future a college degree from applicants for the C. P. A. certificate. I think that general cultural courses should receive a considerable amount of emphasis and that technical courses should be made available, designed with the primary objective of meeting the requirements of the professional accountant rather than the needs of the man who wants to learn accountancy for use in general business or for some other reason. While the most effective technical education can probably be given in a graduate school devoted exclusively to training potential public accountants, practical considerations require that

*A paper presented before a meeting of members of state boards of accountancy, at the annual meeting of the American Institute of Accountants, Chicago, Illinois, October 15, 1934.

for a considerable time, at least, most of this work be done in undergraduate courses.

I believe in that platform because there has been a vital change in the work of our profession since its present educational requirements were fixed. The basic function of a public accountant is the ascertainment, in his independent and impartial capacity, of financial facts from records and other sources. In the early days when the financial structure of business was simple, these facts could be presented in simple form to bankers, investors, lawyers and others for interpretation. Now, however, our financial structures are very complex, and, while our basic function is still to ascertain financial facts, it is necessary for public accountants to exercise judgment and skill in setting forth these facts in reports in such a manner that they may be properly interpreted by others. Moreover, our clients are depending more and more on us for the interpretation of the significance of financial facts as well as for their determination. And it seems quite logical to me that this should be so, since we are impartial and intimately acquainted with the situation. Now there is a considerable difference between ascertaining a fact and expressing an opinion about it—the difference is that the opinion may turn out to be wrong. No one can be right always, but one doesn't get many requests for his opinion unless he is usually right.

I think we must be prepared to break away from some of our traditions and accept more responsibility for the interpretation of facts if our profession is to attain its proper place in the social and economic life of our country. In fixing that place, I am assuming that the present widespread ownership of the capital used in business will continue or increase, and that there will be no basic change in our economic system. And if we are to act in that capacity, we need intellects that have been trained by a well balanced education.

Members of boards of examiners are charged with the technical responsibility of granting the C. P. A. certificates to those applicants who meet the requirements of the laws and of the board's rules of the respective states. I am sure that all meet this responsibility faithfully. The profession and the public owe a continuing debt of gratitude for the arduous labors which examiners perform each year in conducting examinations, marking papers and scrutinizing the files of applicants. But it seems to me that there is an opportunity for service that goes much further. The

requirements of practice will elevate educational standards in time, but progress would be much more rapid if more education were required by law. I think examiners can make a real contribution toward attaining this objective by helping to raise the educational requirements for the C. P. A. certificate in their respective states. In other words, I believe that examiners faithfully operate the machinery now in use to ascertain who should become C. P. A's, and we might describe this machinery as a form of "filter," but I believe an even greater service might be rendered by helping to improve the "filters" and thus present to the public a higher average type of C. P. A. than there is at present.

I served on the legislation committee of the New York State Society for a number of years and know full well the difficulties, and also the dangers, of attempting to change the C. P. A. laws. In a number of states, the boards appear to have full power to fix the requirements, but I imagine that in most cases their hands would be tied, one way or another, if they attempted to make any radical changes in their present rules. But examiners' influence with state education departments is great, and their practical experience in dealing with applicants will cause the legislators to listen with respect. We must assume that it is safe to come forward with a sound program even if it involves a change in the laws. Moreover, suggestions to elevate educational standards for applicants for the certificate, if coming from examiners originally, as officers of states representing the public, will not be looked upon with suspicion, as might be the case if these suggestions were brought forward by the state C. P. A. societies or by any other organization of accountants. There are always those who are ready to charge selfishness, however unjust the charge may be, when those engaged in any vocation try to elevate their standards by increasing the requirements to be met by new practitioners who wish to be admitted.

I have had a summary prepared of the present educational and experience requirements for the C. P. A. certificate as contained in the laws and the board rules of the respective states. These constitute, with the examinations set by the boards, the "filters" used at present by the respective boards of examiners.

All states, except Georgia and Washington which have no formal educational requirements, appear to require a high-school education or its equivalent at the present time. Of the remaining states, sixteen have the high-school requirement in the board rules

and the others have it in the law. In New York the present requirement is graduation from high school, but after January 1, 1938, every candidate for examination for a certificate as a certified public accountant shall present evidence that he has satisfactorily completed a regular course of study in a college or school of accountancy registered by the department as maintaining a satisfactory standard and that, prior to the beginning of his course of study in such college or school of accountancy, he satisfactorily completed a four-year high-school course approved for this purpose or the equivalent as determined by the commissioner of education. I shall have more to say about this New York provision later.

The experience requirements are more difficult to summarize intelligently since there are many variations, as between states, in the type of experience required. However, the following is a rough summary of the experience requirements.

Delaware, Georgia, Montana, Washington and Illinois appear to have no experience requirements, although the latter state does not permit a C. P. A. to practise until he is registered as a public accountant, for which three years' experience is required. Three states require one year's experience; thirteen states and Puerto Rico require two years'; twenty-two states, the District of Columbia and the Philippine Islands require three years'; three states require four years' and two states and Hawaii require five years' experience.

Higher education is not required in any state, but it is recognized as replacing the experience requirement, in whole or in part, in a number of states. In six states, an accountancy-college graduate receives credit for the entire experience requirement; in five states he gets credit for one year's experience, in four states for two years' and in two states for three years' experience. In the other states, there is no provision in the law or in the rules for giving the applicant any credit for higher education.

I think we shall have to admit that the C. P. A. examination is, at the present time, by far the most important part of our "filter," if I may again use that term. No one can honestly believe that graduation from a high school is much direct evidence of potential ability as a public accountant. The experience requirement, which in many cases is met by work as a junior, is not much more effective, particularly since employing accountants are frequently reluctant to admit that the work of their assistants was not satis-

factory, either because it is embarrassing to the employer to do so or because they do not wish to go on record as to something that they think might possibly be unjust to the young man, so that it is not practicable to ascertain whether or not the applicant's work was really of a satisfactory standard.

The C. P. A. examinations have been quite a satisfactory filtering process, and the reputation of the profession has been built up a great deal by their use, but they are far from ideal when relied on alone. Many men are temperamentally not fitted to show their real ability in answers to a single set of examination questions, which must be prepared under considerable nervous strain and pressure as to time—particularly if they are without much previous experience in sitting for examinations; others make showings far better, relatively, than are warranted by their abilities.

Whenever I think of examinations, I recall an experience of my own. I was down on the Mexican border for about nine months during late 1916 and early 1917 as an enlisted man in the cavalry of the New York national guard. Upon our return, feeling certain that we were about to enter the world war, I was anxious to obtain a commission as a second lieutenant and presented myself for an oral examination to a board of officers on Governor's Island in New York. They questioned me about drill regulations, map reading, military tactics, etc., and apparently were well satisfied with my answers. Then they started to ask me questions about the diseases of a horse. Now, I had had a strenuous experience as chambermaid and valet to horses for nine months, but the veterinarian had taken care of their diseases and no one had tipped me off that I had to know about them for that examination. When it became evident that I could not answer the questions they asked me, a kindly officer said he was very sorry, but I could not be passed. I must have looked quite dejected, for he finally gave me a book on horse diseases and told me to go outside and study it and come back in the afternoon. I spent the next five hours sitting on a bench in the park on Governor's Island simply absorbing that book, and when I went back in the afternoon I was letter perfect on colics, spavins, splints and related subjects and I received the commission, and probably changed the course of my military career quite a lot as a result of that incident. But I did not feel then or at any time since that I really knew anything about the diseases of a horse. Fortunately, we always had plenty of "vets." in France who did.

Now I do not think it would be nearly as easy to pass a C. P. A. examination on that basis, but much can be done along the same line. I recall that I took a coaching course from the late Paul Esquerré before I took the examination in New York, and, while he always emphasized in his talks that he was training men to be accountants rather than to pass examinations, I feel certain that, to me at least, his course was much more valuable for the latter purpose.

The most important weakness of our present C. P. A. examination system is that it emphasizes the testing of the technical education of the applicants but does very little to test their general intellectual education. I doubt whether it would be practicable to expand the C. P. A. examinations themselves so that they would constitute a real test of general intellectual education.

It might be well to go to Webster for a few definitions at this point. He says:

“Education, in a broad sense, comprehends all that disciplines and enlightens the understanding; corrects the taste and forms the manners and habits of man. Intellectual education comprehends the means by which the powers of the understanding are developed and improved and knowledge is imparted. Technical education is intended to train persons in the arts and sciences that underlie the practices of the trades or professions.”

We all recognize that the educational qualifications, particularly the intellectual education, of the mature persons with whom we are acquainted differ. Many of our most famous and distinguished citizens of the past and of the present have amply demonstrated that it is not necessary to go to college or to follow any other formal procedure to become educated, either intellectually or technically. We know that heredity, physical qualifications at birth, health during life, environment, education guided by others and self-education all have an effect on intellectual attainments at maturity. I do not know of anyone who has attempted to show the relative effect of each of these factors. But, I am well aware of the fact that the benefits of a college education are not appraised as equally valuable by everyone—in fact, some prominent men have publicly stated that they consider it a detriment. I think that the weight of evidence would be very much against the latter conclusion for the average young man. If a man is capable of becoming educated at all, he should arrive at a certain point much more rapidly if he has the benefit of formal

guidance during his early years than if he relies on his own independent pursuit of knowledge. That this is so is evidenced by the average ages of the seven hundred men who were admitted as members of the American Institute of Accountants during the period from January 1, 1927, to September 1, 1934, which were:

	Educated in the United States	Educated outside the United States
Not high-school graduates.....	40.4 years	42.2 years
High-school graduates.....	37.4 years	38.4 years
College graduates.....	34.6 years	39.5 years

A study of the applications of the 1,406 men who were admitted to the New York State Society of Certified Public Accountants from April 1, 1927, to September 1, 1934, shows that they received their original C. P. A. certificates and joined the society at the following average ages:

	Educated in the United States Average age when		Educated outside the United States Average age when	
	C. P. A. certificate was received	Admitted to society	C. P. A. certificate was received	Admitted to society
High-school graduates.....	31.6	33.7	42.6	43.8
College graduates.....	28.4	30.6	48.0	48.0

These statistics appear to indicate that the average college graduate has not only made up the time spent acquiring a formal education by the time he has been admitted to the Institute or to the New York society but is really from 2½ to 3 years in advance of the high-school graduate and, in addition, he should be better equipped intellectually to forge ahead from that point.

It is also interesting to note the large number of the new members admitted to the Institute and to the New York society during recent years who have been college graduates.

During 1927, we made a study of the records of the members admitted to the Institute during the period of ten years from 1917 to 1926 inclusive which showed:

Educated in United States:	Number	Per cent.
Not high-school graduates.....	240	27.5
High-school graduates.....	278	31.8
College graduates.....	179	20.5
Total.....	697	79.8

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	Number	Per cent.
Educated outside United States:		
Not high-school graduates.....	91	10.4
High-school graduates.....	71	8.1
College graduates.....	15	1.7
Total.....	<u>177</u>	<u>20.2</u>
Grand total.....	<u>874</u>	<u>100.0</u>

A survey of the Institute's application files recently completed for the years 1927 to 1934, inclusive, shows the following:

	Number	Per cent.
Educated in United States:		
Not high-school graduates.....	73	10.4
High-school graduates.....	316	45.2
College graduates.....	227	32.4
Total.....	616	88.0
Educated outside United States:		
Not high-school graduates.....	9	1.3
High-school graduates.....	64	9.1
College graduates.....	11	1.6
Total.....	<u>84</u>	<u>12.0</u>
Grand total.....	<u>700</u>	<u>100.0</u>

During the period of ten years ended in 1926, the percentage of new members who had received regular degrees from recognized colleges averaged about 22%; for the eight years ended in 1934, 34% of the new members were college graduates, or an increase of 12% over the preceding period.

It is also interesting to note that the percentage of new members of the Institute who have been educated outside the United States has decreased from 20.2% during the ten-year period ended in 1926 to 12% during the eight-year period ended in 1934. Of 306 members admitted during the last two years, only 10.1% were educated outside the United States.

The analysis, previously referred to, of the new members admitted to the New York society from April 1, 1927, to September 1, 1934, disclosed the following:

	Number	Per cent.
Educated in United States:		
High-school graduates.....	588	41.8
College graduates.....	755	53.7

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	Number	Per cent.
Educated outside the United States:		
High-school graduates.....	60	4.3
College graduates.....	3	.2
Total.....	<u>1,406</u>	<u>100.0</u>

This increased formal education of our new members has been purely voluntary on their part and is not the result of any requirement to engage in practice, to receive the C. P. A. certificate, or to become a member of the Institute. It indicates that among the responsible practitioners of public accountancy at the present time, there are many men who thought this training would be of enough value to them in their work to warrant the expenditure of the necessary time and money to obtain it.

A discussion of this kind can not stop with an endorsement of a college education without referring, to some extent, to the studies that should be pursued in college by a prospective public accountant. If I knew of a single college in the United States which considered that its principal job, or even one of its major jobs, was to train men to be public accountants, this part of my task would be much easier, for I would merely refer to its curriculum, always assuming that it was doing its job well. For a number of years I have been trying to discover such an institution without success. There are almost two hundred collegiate schools of business which give accountancy training of one kind or another, and many other colleges also have courses in accounting, but in all of them by far the larger part of their students take up work other than professional accountancy after they graduate. This is evident from a report of the United States office of education issued in September, 1929, in which it is stated that in 1928, 56,340 students were taking courses in accountancy in 348 institutions and that 5,636 students were majoring in accountancy in 46 colleges. We know that if we could obtain all the young men available for the profession each year from this source, it would be possible to absorb only a small fraction of the number. Under these conditions, it is quite natural that the courses are not designed, and the teaching staff is not selected, to meet the requirements of the potential public accountants but rather to meet the requirements of the other students. If a young man were to ask me what college he should attend and what courses he should pursue to get the best education for the practice of law, medicine

or engineering, it would be easy for me to refer him to a half dozen or so outstanding institutions. I have not been able to give such a ready answer to young men who have asked the same question about professional accountancy.

It was partly this situation which caused the Institute's committee for placements, during the period of its operation, to adopt the principle that we were not so much concerned with what a young man recommended for employment in the profession had studied in college as we were with the scholastic record he had made and with his personality and natural qualifications. A further reason for the adoption of that principle was our conviction, based on our experience in employing men for our own offices that, at that time, the natural qualifications of the students applying for positions with us from the collegiate schools of business, particularly as revealed by their personalities, did not, in general, measure up to those from the other courses. I might add that this committee was organized in 1926 because a number of prominent public accounting firms had become convinced that some organized effort should be made to improve the new blood that was coming into the profession, and we agreed that this could best be done by encouraging more properly qualified college graduates to enter it. We did not, of course, discriminate in any way against men with degrees from the collegiate schools of business, although there have been some misunderstandings on that point. We simply took the position that we were primarily concerned with intellectual education and pleasant personalities. If we could get those and technical education also, so much the better. But if we had to choose, we favored intellectual education, because we felt we could give the boys the technical education in our own offices, whereas we could not give them an intellectual education nor alter their personality.

Some listeners may be interested in knowing the institutions attended by the 227 new members having college degrees who were admitted to the Institute during the last eight years. They came from 69 different colleges and universities in all sections of the United States. Only the following 14 supplied five or more graduates each:

New York university.....	38
Harvard university.....	17
University of Pennsylvania.....	17
University of Illinois.....	15

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Columbia university	7
University of Washington	7
University of Wisconsin	7
University of California	6
Dartmouth	6
Northwestern university	5
University of Maryland	5
University of Michigan	5
University of Chicago	5
University of Texas	5

New York university is considerably in the lead, but not so far ahead as during the period of ten years ended in 1926, when that institution supplied 57 out of a total of 179 college graduates who joined the Institute.

The 755 college graduates who became members of the New York State Society of Certified Public Accountants during the same eight-year period came from 48 different colleges and universities throughout the United States. The following 11 institutions supplied 5 or more graduates each:

New York university	558
College of the City of New York	58
Columbia university	19
University of Pennsylvania	11
Cornell university	9
Fordham	9
St. John's college	7
Syracuse university	6
St. Lawrence university	5
University of Illinois	5
University of Michigan	5

In the New York society, New York university is far in the lead.

In addition to knowing the colleges attended, we are interested in knowing the degrees received and the ages at which the recipients were admitted to the Institute and received their C. P. A. certificates.

The degrees received by the 227 members admitted to the Institute and the average ages at which they were admitted follow:

	No. of degrees	Average age
Graduates who studied principally general cultural courses:		
Bachelor of arts	62	35.6 years
Master of arts	7	35.0 years
Bachelor of philosophy	6	34.0 years
Doctor of philosophy	2	45.5 years

Education for Professional Accountants

	No. of degrees	Average age
Bachelor of laws	10	35.1 years
Master of laws	1	47.0 years
	<hr/>	<hr/>
Total for general cultural courses	88	35.7 years
Graduates who studied principally technical courses:		
Bachelor of commercial science	51	35.4 years
Master of commercial science	1	43.0 years
Bachelor of business administration	9	32.6 years
Master of business administration	11	31.5 years
	<hr/>	<hr/>
Total for technical courses	72	34.6 years
Graduates who studied courses not readily determinable from degrees received:		
Master of science	6	34.5 years
Bachelor of science	54	32.8 years
Mechanical engineer	2	44.5 years
Degrees not stated in application	5	31.4 years
	<hr/>	<hr/>
Total other courses	67	33.2 years
	<hr/>	
	227	
	<hr/>	

While the bachelor of science degree does not indicate the courses studied as well as the other degrees, a general scrutiny of the list of colleges by which they were granted indicates that considerably more than half of them probably consisted principally of general cultural courses.

The degrees received by the 755 members admitted to the New York society follow:

	Number	Average age at which C. P. A. certificate was received
Graduates who studied principally general cultural courses:		
Bachelor of arts	64	32.8 years
Master of arts	8	36.1 years
Bachelor of philosophy	5	32.4 years
Bachelor of laws	25	31.0 years
	<hr/>	
Total general cultural courses	102	32.6 years

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		Average age at which C. P. A. certificate was received
Graduates who studied principally techni- cal courses:	Num- ber	
Bachelor of commercial science.....	534	27.4 years
Master of commercial science.....	2	24.5 years
Bachelor of business administration....	20	25.3 years
Master of business administration.....	9	26.1 years
	565	27.3 years
Graduates who studied courses not readily determinable from degrees received:		
Bachelor of science.....	86	30.8 years
Master of science.....	2	29.5 years
	88	
	755	

New York university granted 34 of the 51 degrees of bachelor of commercial science held by Institute members and 532 of the 534 similar degrees held by members of the New York society. Most of the holders of the graduate degrees of master of business administration also hold undergraduate degrees based on the so-called cultural courses. It is evident, therefore, that, if we eliminate the effect of New York university for a moment, the effect of the other colleges in the country on education for professional accountants has been along the lines of intellectual education rather than technical education. It also appears that graduates of general cultural courses enter the Institute at approximately the same age as graduates of technical courses. While the technical graduates received the C. P. A. certificate in New York about five years before the others, the comparison is distorted by the fact that a great many of the technical degrees were received as a result of night courses taken while the students were employed.

I think it is fair to say that the influence of New York university has been almost entirely directed towards technical education and its influence in that direction has been very important, as is shown by the large number of her graduates who have entered the profession. That the curriculum is designed principally to supply technical education is shown by the catalogue of her school of commerce, accounts and finance which states that "the profes-

sional courses of study are planned with two objects in view: to increase the students' knowledge of business operations and to develop his ability to solve business problems." Credit for the satisfactory completion of 128 points of classroom work is required for the B.C.S. degree, of which 28 points must be general cultural courses and 100 points must be business courses. The general cultural work, as shown by a typical program in the catalogue, consists of the equivalent of four hours a week in the classroom, for one term of seventeen weeks, in each of the following: outlines of history, outlines of science, outlines of literature, general mathematics, general psychology, relation of government to business, and economic principles and problems.

Having said at the beginning that I have had no experience in formal educational technique, I make my next remarks with considerable diffidence. However, I venture the statement that this course and similar courses in other institutions would afford more valuable training for professional accountants if more time were devoted to the so-called cultural courses, and if more emphasis were placed on those of the technical courses with which the work of the public accountant is directly concerned after he goes into practice. I believe also that potential public accountants should be segregated in classes for at least some of their technical courses and for lectures by distinguished accountants in active practice, in order that esprit de corps may be developed. While this may sound like criticism of the course of study offered, it is not really that. It is only a plea for courses designed particularly for potential C. P. A.'s.

The foregoing comments are based on the assumption that education has two principal functions in the development of the intellect: first to develop its power to analyze, to reason and to reach proper conclusions from a certain set of facts; second, to supply the mind with a fund of knowledge. The first function, which to me seems by far the more important, is, as I understand it, better carried on through those courses which require the student to think, than by those which I might describe as "information giving," even though the subject matter of the latter might at first thought appear to have a more direct bearing on what the young man needs to know when he goes to work. In other words, I believe that mental power is better developed by exercising the brain than by emphasizing the development of the memory too much.

If any institution will organize a proper course of study primarily for public accountants and will use some discretion as to the students it accepts, its success as an incubator of public accountancy is assured. The fact that it is easier to select proper raw material for a particular profession after four years of college than after high school is one reason why a graduate course for the technical subjects should be better than an undergraduate course, but, as I have said before, considerations concerning the amount of time young men can afford to give to acquire an education point to undergraduate courses as the most practicable at the present time. Accountancy practitioners are eager to obtain for their staffs technically trained men who measure up to their requirements as to personality and intellectual education. Practitioners also have a real duty so to arrange their affairs that a reasonable number of properly educated new staff assistants can be taken on each year as permanent employees, if their work and conduct are satisfactory.

I have previously referred to the new law in New York under which all applicants for the C. P. A. certificate after January 1, 1938, must submit evidence of a college education in accountancy. If that law had previously been in effect, the 88 holders of degrees from general cultural courses, and most of the 54 holders of B.S. degrees, who became members of the Institute during the last eight years could not have received the C. P. A. certificate in New York unless they first took a two-year graduate course in such graduate schools of business administration as Harvard, N. Y. U. or Columbia or received a degree from a four-year course in one of 33 collegiate schools of business approved by the state department of education. The same statement applies to almost all the college graduates who became members of the New York society during the same period, except those who came from the College of the City of New York and from New York university with B.B.A. or B.C.S. degrees. It will mean also, I assume, that any holders of C. P. A. certificates of other states who desire a New York certificate by reciprocity will be required to meet these new educational requirements after January 1, 1938.

I should have liked the new law better if graduation from any approved college with any degree had been made a prerequisite for the certificate rather than graduation from a school of commerce. However, we are now faced with the law as it is. It seems to me that it is a direct challenge to the colleges of com-

merce which are approved to turn out well-rounded C. P. A's. I hope it will have sufficient effect in that direction that, with the elimination of the men with only a high-school education, we shall be compensated for any loss we may sustain in men with degrees in the liberal arts or sciences who might otherwise have entered the profession with success. I hope, too, that the new law will encourage more of the latter type of men to take courses in the graduate schools of accountancy, and that we may develop at least a few of these courses which will become valuable experimental laboratories for improvements of the practice of our profession. I should like to reiterate my belief, frequently expressed elsewhere, that one of the greatest needs of our profession is one or more colleges, or divisions of colleges, which are willing and able to devote themselves exclusively to the education of young men for professional accountancy.

In closing, may I revert to the suggestion I made at the beginning when I said examiners were in a position to contribute much towards this movement. I think the time has arrived when every state should seriously consider replacing the high-school requirement for the C. P. A. certificate by a college degree. Whether the boards accept any degree or a particular degree, is a matter for individual judgment. In making the change, it will be necessary to give from four to six years' advance notice in order that young men may have ample time to make their educational plans accordingly. In view of the time that must elapse between the change in the law and the effective date, the subject should be discussed as early as possible.

Revenue Act of 1934*

BY WRIGHT MATTHEWS

If I were permitted absolute freedom to choose the group with which I should prefer to discuss the problems involved in my work, I would unhesitatingly select the American Institute of Accountants. The profession of accountancy for the last twenty years has been an integral part of our taxing system. Our principal sources of revenue have been derived from transactions and activities, for which the forms of record have been prescribed by the accountancy profession. The accuracy of these records has depended upon accountants' proficiency. Although the legal profession, to which I have the privilege to belong, has inevitably been engaged in the work of interpretation and litigation, it has devolved principally upon accountants to blaze the trails in modern tax administration.

In coming here, therefore, I feel I come to a sympathetic and understanding audience. At this particular juncture, those of us engaged in governmental administration are in need of sympathy and understanding. I am grateful for this opportunity to talk about our federal tax problems.

It was only natural at the outset of President Roosevelt's administration that the most conspicuous policies and actions would be those involving not the collection of revenue, but the expenditure of money. Disputatious critics may argue about the form, manner and wisdom of these expenditures. The limits of time as well as the obvious purpose of my talk, restrict me to a discussion of the ways and means of paying the bill.

The decade prior to 1920 marked a fundamental change in our federal taxation policy. It marked the opening up of a new and different source of revenue. The corporation excise tax of 1909 and the income-tax law of 1913 were the forerunners of the ready means whereby the government gathered the unprecedented revenue needful to the prosecution of the war.

The war period was followed by another decade, to which many different appellations have been applied. From the point of view of policy and administration this decade was principally devoted

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Revenue Act of 1934

to the settlement of important tax disputes arising primarily out of the war period and to lightening of the tax burden. The unprecedented economic activity of the decade which ended with 1930, probably accounts for the failure of the government to be more farsighted in the matter of perfecting its system of taxation. During that decade miscellaneous excise taxes generally were dropped from the system; the revenue from income taxes was ample for the current needs of government.

During the last year the treasury department has conducted an intensive study, including personal investigation of some features of foreign taxing systems. The object of this study has been to recommend to congress a general program designed to produce necessary future government revenues with the least possible disturbance to business. This undertaking has been made especially difficult by the fact that municipalities and states, in their need for revenues, have either preëmpted certain fields and objects of taxation or have pyramided their local imposts on taxes already imposed by the federal government. Under our system of government, it is extremely difficult to coördinate these innumerable local systems of taxation with our federal system.

We have read lately of the tax burden of the American people. It is my observation that the American people are not unduly tax-burdened. We are tax-conscious. This idea, perhaps, sounds strange. Its truthfulness can be demonstrated. In the United States a single person with a net income of \$1,000 pays no tax. In England such a person pays an income tax of \$33.75. In the United States a married person with a net income of \$2,500 pays no tax. In England such a person pays a tax of \$182.81. In the United States a single person with a net earned income of \$10,000 pays a tax of \$560. In England such a person pays \$1,701.56, or more than three times the amount paid by a citizen of the United States. In the United States a married person with a net income of \$40,000 pays a tax of \$5,979. In England such a person pays a tax of \$13,242. During the fiscal year 1932 the United States collected \$1,056,756,697 in income and profits taxes on net incomes totalling approximately \$17,300,000,000. During the same year England collected \$2,123,835,520 in income and profits taxes on net incomes totalling approximately \$13,800,000,000.

The specific exemption allowed a single person in England is \$500 compared with \$1,000 in the United States. The specific

exemption allowed a married person in England is \$750 compared with \$2,500 in the United States. The normal rate of tax in England is $22\frac{1}{2}\%$ of the net income. However, on the first \$875 above the specific exemption the tax is one half of the normal rate or 11.25%, and 20% of earned income not exceeding \$1,500 is exempt. Including taxes, both national and local, the per-capita tax burden in England is about 40% greater than the per-capita tax burden in the United States. The per-capita public debt of England, including the debt of the local subdivisions, is approximately two and one half times the per-capita public debt of the United States and the states including their local subdivisions. In fact we could go in debt seventy-two billion dollars more before we arrived at the same per-capita debt as England.

We are confronted today with the need for revenue as great as that which confronted us during the war. It is a strange and unaccountable phenomenon that those able to pay taxes should be willing to give up their last penny to defend the country against an enemy outside our gates and should be contrarily inclined when fighting an enemy even more dangerous within our gates. Unlike the war period, with its rapidly expanding and unprecedented profits, the present period is largely one of vanished or very slim profits. With income diminished, it was inevitable not only that most rates of income taxes be raised but that new objects of taxation must be found. For example, income taxes for 1929 amounted to \$2,331,274,428.64, and all other taxes to \$607,779,946.79. For the fiscal year 1934 income taxes amounted to \$817,025,340, and all other taxes to \$1,483,790,969. These figures clearly show the trend which necessity has dictated. The figures do not include processing taxes, which in 1934 amounted to \$371,422,885.64.

As technicians, accountants will understand that the duty of administrative officers is primarily to deal with the facts. We can contribute our experience to those who determine questions of policy, but primarily our job is to administer the law as it is given to us with respect to the facts as we ascertain them to be.

Certain provisions of the 1934 act were prompted by a condition which reminds me of the story of the man who was examining applicants for position as coachman. Each candidate was submitted to the same test question. The employer took the candidates to his veranda. Pointing out a precipice, he asked each

candidate how closely he could drive a coach and four to the edge of the precipice without falling over. Varying answers were given, of course, each candidate estimating the proximity with which he could approach the precipice without danger to the occupant of the coach. Finally, one candidate answered the question by saying that if it were his good fortune to be selected for the job, it would be his constant purpose to keep the coach and four as far as possible away from the precipice. Needless to say, he got the job.

The experience of the bureau, in regard with what are commonly called "loopholes" in past statutes, has been that taxpayers have been inclined to employ the coachman claiming the greatest skill in driving close to the edge of the precipice. In some of its provisions the 1934 statute was designed to keep taxpayers and their advisors away from the precipice and to serve notice that those who elected to display their skill in driving close to the edge would do so at great risk.

In approaching technical questions, I do so with much trepidation, for two reasons: first, because of my own limitations, and second, because of the comprehensiveness of the subject matter. A discussion of particular changes made by the revenue act of 1934 would be to paraphrase that act.

There is one phase of every revenue act in which all taxpayers and their representatives have a common interest. I refer to the statute of limitations. Failure to protect a client's rights within the time allowed by law is inexcusable.

Statutory periods governing estate, gift and miscellaneous internal revenue taxes have not been modified materially in the 1934 revenue act. The provisions relating to estate and gift taxes continue as before, that is, generally speaking, there is a period of three years from the date when the return was filed, within which the commissioner may assess the tax (section 310, revenue act of 1926; section 517, revenue act of 1932), and the same length of time, that is, three years, running from the date the tax was paid, within which a refund or credit may be allowed to the taxpayer or a timely claim filed by the taxpayer (section 319 (b), revenue act of 1926, as amended by section 810 (a), revenue act of 1932; section 528 (b), revenue act of 1932). A corresponding period of four years applies in the same manner to the assessment and to the refunding or crediting of all miscellaneous taxes. Section 1109, revenue act of 1926, as amended by section 619 (a),

revenue act of 1928; section 3228, *Revised Statutes*, as amended by section 1106, revenue act of 1932.

Important changes have been made in the revenue act of 1934 in the periods of limitation applying to income taxes.

First, the general period within which assessment may be made or a court proceeding be begun without assessment, running from the date of the filing of the income-tax return, has been extended to three years as compared with the two-year period provided in the revenue acts of 1928 and 1932. (Section 275 (a).) This provision (as in the case of all other provisions of title I of the act relating to income tax) applies to taxable years beginning after December 31, 1933. A change has also been made in the time within which a "prompt assessment" must be made, where a request for such an assessment is filed by a representative of a deceased taxpayer or a corporation about to be dissolved. (Section 275 (b).) The period in this instance is now eighteen months instead of twelve months. Of course, the running of the three-year period is suspended whenever a statutory deficiency notice is mailed before its expiration (section 277), and it may be extended by a proper waiver. (Section 276.) The new act also specifies that the three-year period does not begin to run before the last day on which the return was due, even though the return was filed before that day. (Section 275 (d).)

The second important change having to do with statutory limitations appears in section 275 (c) of the revenue act of 1934, and is of a kind new to our income-tax laws. This section provides that, if a taxpayer omits from gross income an amount which should have been included, which is in excess of 25% of the gross income reported, assessment of the tax may be made at any time within five years after the return was filed. This new provision should encourage a voluntary disclosure by the taxpayer in his return of all facts relating to important transactions, the taxable status of which may seem doubtful to the taxpayer.

A third change of importance is the lengthening of the time for making allowances of refunds and credits and for the filing of claims for such allowances. The period for making refunds and credits has been changed to three years from the time the return was filed, or two years from the time the tax was paid, whichever period expires the later, unless a claim is filed within one of those periods. (Section 322 (b).) This section also contains a new provision to the effect that, where overpayments are found by the

Revenue Act of 1934

board of tax appeals, no refund or credit can be made unless the board finds in its decision that the tax was paid within three years from the filing of the claim, or of the petition, whichever is earlier. (Section 322 (d).) It should be pointed out that prior acts have also been amended to enlarge the jurisdiction of the board to cover the statutory status of overpayments, section 504. These provisions make it unnecessary for a taxpayer to resort to the courts because the commissioner holds that an overpayment determined by the board is not refundable.

In addition to these changes, which apply principally to income taxes imposed by the revenue act of 1934, changes have been made in the periods of time applicable to the filing of petitions with the board of tax appeals and the commencement of proceedings in the courts. The most important change of this type is the lengthening of the period for filing a petition with the board from sixty days to ninety days after the date of the registered letter, which is sent by the commissioner as a notice of his final determination. (Sections 272 (a) and 501.)

With respect to suits brought by the commissioner for erroneous refunds, section 502 of the new act amends section 610 of the 1928 act to permit such a suit within five years in cases where the refund was induced by fraud or misrepresentation, but this provision does not apply where the two-year period expired before the enactment of the 1934 act.

Probably no changes brought about by the new revenue act have provoked more discussion among tax accountants and tax attorneys than those changes relating to capital gains and losses. Tax services and tax magazines during the past few months have commented freely on this subject. It does not appear either necessary or advisable that I should try to answer at this time any of the questions which have been and are now being raised about these new provisions.

Section 117 of the 1934 act provides an entirely new method for treating capital gains and capital losses. There is no longer any special tax rate applicable to these transactions as in prior law beginning with the 1921 act. The system of limiting losses upon the sale of stocks and bonds, as provided in the 1932 act, has also been superseded.

Under the 1934 act, in the case of a taxpayer other than a corporation, the gain or loss upon a sale or an exchange of property is recognized upon a graduated percentage basis, depending upon

the length of time the asset was held by the taxpayer. The percentage of gain or loss recognized varies from a minimum of 30%, if the property has been held more than ten years, up to 100%, if held for not more than one year. (Section 117 (a).) The rules for determining the period for which a capital asset has been held are similar to the corresponding provisions in the revenue act of 1932.

Capital assets are defined in section 117 (b) of the new act and, broadly speaking, they may be said to include all property held by the taxpayer, except property of a kind which should be inventoried at the close of the year or property held for sale to customers in the ordinary course of the taxpayer's business.

Section 117 (d) limits the allowance of losses from sales or exchanges of capital assets to the sum of \$2,000 plus the gains from such sales or exchanges. This is an important limitation, which affects all taxpayers, including corporations, except that, under certain conditions, capital losses from sales of bonds, notes and like securities suffered by banks and trust companies doing a deposit business are not so limited. There is also an important limitation upon losses contained in section 24 (a) (6) of the new act, which provides that no deduction shall be allowed for losses from sales or exchanges of property between members of a family or between a person and a corporation controlled by him, except in the case of distributions in liquidation.

Gains or losses from "short sales" of property are considered as gains or losses from sales or exchanges of capital assets. (Section 117 (e).) Amounts received from the retirement of corporate bonds are considered as amounts received in exchange for the bonds. (Section 117 (f).)

Dr. Thomas S. Adams is quoted as having said that the only complication in taxing statutes is the rate. The income-tax title of the revenue act of 1934 is applicable to taxable years beginning after December 31, 1933. There is imposed a normal tax of 4% on the amount of the net income in excess of the exemption and credits instead of the 4% and 8% normal tax provided by the revenue act of 1932. The surtax is imposed at graduated rates upon the "surtax net income" and ranges from 4% on surtax net income in excess of \$4,000 and not in excess of \$6,000 to 59% on surtax net income in excess of \$1,000,000. The "surtax net income" is the amount of the net income in excess of the personal exemption and credit for dependents.

The privilege of making consolidated returns has been limited in section 141 to affiliated groups of corporations, each of which is either (a) a corporation whose principal business is that of a common carrier by railroad or (b) a corporation, the assets of which consist principally of stock in such corporations, which does not itself operate a business other than that of a common carrier by railroad. An additional tax of 2% is imposed under section 141 (c) for the privilege of making such consolidated returns.

The commissioner is still authorized to allocate gross income or deductions in the case of two or more organizations if this be necessary to prevent evasion of taxes or clearly to reflect the income of such organizations. (Section 45.) The new act extends the application of this section to every form of organization whether or not engaged in a trade or business.

A subsection relating to the publicity of certain information in the returns is a new feature in the revenue act of 1934. (Section 55 (b).)

Another new section provides for a surtax on "personal holding companies." The tax is at the rate of 30% upon the amount of the "undistributed adjusted net income" not in excess of \$100,000 and at the rate of 40% upon the amount of the "undistributed adjusted net income" in excess of \$100,000. (Section 351.)

The definition of the term "reorganization" has been changed in section 112 (g) of the act, so as more clearly to define the term. In the revenue act of 1932 (section 112 (i) (1) = (A)), the term "reorganization" was defined as "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)." The corresponding provisions of the new act in section 112 (g) define the term "reorganization" as "(A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation." The remaining provisions relating to the definition of a reorganization are the same as those of the revenue act of 1932.

Another change in the law governing recognition of gain or loss in reorganizations is the omission in the new act of the provisions

corresponding to section 112 (g) of the 1932 act. This section of the 1932 act provided that, if there was a distribution to a shareholder in a corporation, a party to the reorganization, of stock or securities of that corporation or of another corporation, a party to the reorganization, without the surrender by the shareholder of any of his stock or security holdings, no gain was recognized upon the receipt of such stock or securities. Under the new law, a gain is recognized to the distributee in such a transaction.

Several important changes have been made in section 113, which governs the determination of the adjusted basis for gain or loss upon the sale or other disposition of property.

In the case of property acquired prior to March 1, 1913, the rule is that, if the adjusted cost is less than the fair market value at March 1, 1913, the basis for determining gain shall be such fair market value, and this was the rule in prior acts. However, the basis for determining a loss is limited by the new act to the adjusted cost, even though the March 1, 1913, value is greater than such cost. (Section 113 (a) (14).)

Another important change relates to partnership property; such property acquired after February 28, 1913, now is on the same basis as it would have been in the hands of the one who transferred it to the partnership, adjusted for any gain or loss recognized at the time of the transfer.

With respect to gifts made after December 31, 1920, the loss to the donee upon the disposition of the gift is limited under the 1934 act to the basis of the property in the hands of the donor (or last preceding owner by whom it was acquired by gift) or to the fair market value of the property at the time of the gift, whichever is lower. (Section 113 (a) (2).)

The law relating to property transmitted at death has been somewhat simplified. Section 113 (a) (5) of the revenue act of 1934 conforms to the language of the revenue act of 1926 and provides in effect that the basis for property valuation, whether real or personal, and whether acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, shall be the fair market value at date of decedent's death.

The basis for depreciation and depletion under the provisions of section 114 is determined in the same manner as the basis for determining gain. Percentage depletion allowances are unchanged in the new act. In the case of coal, metal and sulphur mines, taxpayers are allowed a new election when filing the first

return under the 1934 act, as to whether or not depletion shall be computed on a percentage basis. (Section 114 (b) (4).)

As already pointed out, miscellaneous taxes have far outstripped income taxes. Under the head of miscellaneous taxes we have estate tax, gift tax, capital-stock tax and various excise taxes.

The most important recent change in the estate tax is the imposition by the revenue act of 1932 of an additional tax which greatly increases the federal revenue from this type of taxation. The revenue act of 1926 is still in force and is, in fact, the basic estate-tax law, as the provisions relating to the make-up of the gross and net estates and the necessary administrative provisions are contained in that act. The result is that we are now administering two estate taxes—the tax imposed by the revenue act of 1926 and the additional tax imposed by the revenue act of 1932. Furthermore, an individual estate may now be liable for both taxes.

The method of computing the additional estate tax has not been changed by the revenue act of 1934. However, the maximum rate of 45% under the revenue act of 1932 has been increased to 60% under the revenue act of 1934, as compared with 20% under the revenue act of 1926. (Section 405.) This provision applies only to transfers of estates of decedents dying after May 10, 1934. Estates of non-resident citizens have been placed in the same category with estates of residents, both with respect to the specific exemptions and the inclusion of property in the gross estate. (Section 403.) Real property situated outside of the United States is specifically excluded from the gross estate. (Section 404.)

The gift tax is new, in that no such tax existed at the date of the enactment of the revenue act of 1932, but this tax has an historical precedent in the provisions of the revenue act of 1924. The revenue act of 1934 amends the gift-tax act of 1932 by increasing the rates to a maximum of 45%. (Section 520 (a).) This is an increase that corresponds with the increase made in the estate-tax rates, so that the new gift-tax rates will equal three-fourths of the new estate-tax rates. The new gift-tax rates do not become effective until the calendar year 1935.

A capital-stock tax, effective beginning with the taxable year ended June 30, 1934, is imposed upon corporations with respect to carrying on or doing business. (Section 701.) It constitutes

substantially a reënactment of the capital-stock tax imposed by section 215 of the national industrial recovery act. Exemptions from the tax are provided in section 701 (b) of the act. The tax is measured by the adjusted declared value of the capital stock, instead of the fair average value of the capital stock, and is also payable at the end of the taxable year instead of being payable in advance. As a corollary to the tax to insure the declaration of a reasonable value, congress has imposed an excess-profits tax of 5% on the income in excess of $12\frac{1}{2}\%$ of the adjusted declared value of the capital stock.

The revenue act of 1934 eliminates the tax on certain miscellaneous articles, changes the rates on others, adds new articles to the list of those already taxed and provides additional administrative measures for the protection of the revenue.

Perhaps treasury decision 4422, which has been given considerable publicity during the past few months, has been the cause of concern to accountants. This treasury decision was promulgated February 28, 1934, and was the direct result of a report of the subcommittee of the house ways and means committee dated December 3, 1933, which, in its consideration of revenue legislation, recommended a flat reduction of 25% in the depreciation deductions of all taxpayers which would have been allowable for the years 1934, 1935 and 1936. The treasury department opposed the flat reduction recommended and in a letter dated January 26, 1934, to the chairman of the committee on ways and means, Secretary Morgenthau urged that it would be more equitable to remedy this situation through proper administrative measures rather than through legislation which would arbitrarily reduce every taxpayer's depreciation allowance by a certain percentage whether or not the allowance may have been excessive for past years. Congress recognizing the fairness of the department's attitude and relying on assurances of proper administration made no statutory changes with respect to depreciation deductions, and as a consequence treasury decision 4422 was promulgated.

Subsequently the bureau of internal revenue issued IT:A&C mimeograph Coll. No. 4170, R. A. No. 714, which outlines in detail the procedure to be followed in carrying out the provisions of the treasury decision. It is highly important that everyone interested in the question of depreciation as it relates to income-tax returns study carefully those instructions, for it is believed

that practically all questions that arise with respect to this problem are answered in the mimeograph.

Of primary importance are the instructions with respect to what taxpayers are required to file depreciation schedules and for information I should like to read that portion of the mimeograph:

"In cases where the required information has not been furnished, the revenue agent or other examining officer should advise the taxpayer with respect to the schedule and supporting information which must be prepared. If upon the review of the return of any taxpayer it is apparent that the deduction claimed for depreciation is a very minor factor in determining net income, or that the facts indicate conclusively that the deduction claimed in the return is not in excess of the correct amount, or where it is clearly evident that no taxable income will be developed, the schedules need not be furnished for such year. In all other cases the information required by treasury decision 4422 and by this mimeograph must be furnished and after verification by the examining officer should be made a part of his report."

It is evident, therefore, that taxpayers are not required to file the information called for in treasury decision 4422, unless specifically requested to do so by agents of the bureau, for the returns of many taxpayers will come within the exceptions just mentioned. Before leaving this question I want to give assurance that the bureau desires to administer the provisions of treasury decision 4422 with the least possible burden to taxpayers, and only in those cases where it is evident that the amounts claimed for depreciation have been in excess of reasonable amounts will the information called for by treasury decision 4422 be required. Obviously those taxpayers whose depreciation deductions are clearly excessive and unreasonable will be compelled to reduce their claims for depreciation, with a consequent increase in the income tax to be paid for the years now open. Those taxpayers whose depreciation deductions have been reasonable have absolutely nothing to fear.

One particular phase of the administration of the revenue laws, which it is believed is quite generally misunderstood, is the subject of offers in compromise. Accountants can render us great assistance through clear explanations to their clients of the various features of this problem.

The popular conception of a so-called "compromise case" appears to be that it is something which any bureau officer can do with as he pleases—the result depending more on the quality of such officer's breakfast than on any other element. This may sound like a wild exaggeration, but some such idea is more or less prevalent.

It is clearly the duty of administrative officers to collect taxes properly due. In some cases this can not be done—but the duty remains and, where the tax liability is fixed, extends to the maximum amount recoverable in the particular case.

The law provides that a federal tax lien is a prior claim over general creditors and this is an important point which is quite often misunderstood or overlooked. The law further provides that tax liability is not discharged by bankruptcy. Many taxpayers appear to feel that the government should stand aside and wait for them to pay other creditors first. Regardless of what may be said on this subject, it is obvious that administrative officers can not suspend priorities definitely fixed by statute. Only the legislative branch of our government can do this.

Many taxpayers, in discussing compromise, appear to feel that the bureau of internal revenue is responsible for all of their troubles. Unquestionably, most taxpayers who have found it necessary to file offers in compromise are in plenty of trouble, but it is the purpose of the bureau to aid by every possible legal means in the alleviation of this trouble.

Congress specifies items comprising the basis for taxation and the tax rates applicable to them. Obviously, then, if the tax in question be income tax, it must be that the taxpayer received the income as made taxable by congress; the same rates of taxation were applied as in the case of other taxpayers; and he would be just as able to pay the resulting tax as any other taxpayer, if it had not been for the fact that he has encountered some subsequent economic disaster. Many cases of this kind arise in taxable exchanges of stock, the market values of which have since severely depreciated. The revenue laws and the bureau of internal revenue have suffered much undeserved criticism in such cases. The briefest analysis clearly shows the situation to be due entirely to market conditions, and if market values had remained constant, the tax would have been no more than an unpleasant incident. This comparison is not confined to cases of the above class, but can properly be made in all compromise cases. In all these cases, the predicament in which the taxpayer now finds himself is directly traceable to some unfortunate circumstance occurring subsequent to the taxable period, and frequently entirely dissociated from the facts giving rise to the tax.

It may seem that this analysis of the situation has not softened the final answer, but it is my belief that a clear understanding of

these facts goes a long way toward removing any trace of bitterness from the consideration of these cases.

The older employees of the field service tell of the surprising laxity of accounting and bookkeeping records as late as the outbreak of the world war. It is generally recognized that the administration of the federal revenue acts has been very largely responsible for converting business men to understand the necessity for keeping accurate records which will enable one to determine whether or not an enterprise is actually making money. In a very similar way, I believe that the compromise policy of the treasury department will and should emphasize among business men the advisability of adjusting their federal tax liabilities promptly when they have the profits which form the basis of the tax; to exercise greater care in the preparation of returns, thereby eliminating the possibility of a deficiency liability; and also to set aside in adequate form (preferably in cash or liquid assets) an amount with which to pay accrued taxes and reasonable estimates of taxes.

Besides the new responsibilities incident to the repeal of prohibition, the bureau of internal revenue has had to undertake many additional and novel jobs of administration. Some of these are not primarily problems of tax administration. They fall in the category of the police power. The tax upon "hot" oil, firearms, and upon excessive cotton production are illustrative. We have also a novel experiment in government in the processing tax. The addition of these and other laws to the subjects administered by the bureau of internal revenue has vastly increased the burdens of the secretary of the treasury and the commissioner of internal revenue.

How Accountants Can Serve Municipalities*

BY CARL H. CHATTERS

Municipalities need help in solving their financial problems. They want improved budgeting and accounting. They need trained personnel. Their debts are heavy and their revenues uncertain. Loose talk about excessive governmental expenditures goes unchallenged because cost standards are not used. Conditions are improving. Surely the professional accountants, with their knowledge of financial problems, can bring about permanent improvements in public affairs. They must qualify themselves to serve in this specialized field; they must develop standards, study revenues and expenditures and professionalize the public service. They can serve directly in many ways.

QUALIFYING TO SERVE MUNICIPALITIES

To be of service to municipalities, accountants must first qualify themselves to serve. As a preliminary training they need a thorough knowledge of both general accounting and auditing practice. However, the practice of municipal accounting needs special experience. In order to serve effectively, accountants must acquire an understanding of the economic, social and political questions involved in the financial and accounting problems of government.

I do not imply that an accounting firm must confine itself to this class of work entirely. I do mean, however, that an organization which makes a pretense of being able to conduct a municipal audit without previous experience in municipal affairs is being unfair to its client and to itself. I have no use for the unqualified auditors who are willing to undertake a municipal engagement. One of the outstanding members of the Institute wrote me a short time ago as follows: "I am not absolutely convinced that we need to develop specialists for governmental work to the extent of individuals and firms restricting their practice to work of this type, but I am convinced that it is little short of fraudulent for any firm to undertake an engagement for a unit of government unless it has partners or staff members

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available who have academic and practical training for such an engagement." This expresses my own opinion, and I feel sure that, if such an aim became a reality, both the accounting profession and municipalities would profit.

Accountants, to be of service to municipalities, must recognize the difference between accounting for public and private enterprises. Until they do they are in no position to serve municipalities. They must recognize the different objectives of the two types of organizations. A public corporation exists solely to be of service and not to operate for the profit of a limited group. Municipal property does not serve as a basis of credit in the manner common to the private corporation. Furthermore, the activities of public bodies are hedged about by certain legal and constitutional limitations. A knowledge of these factors is necessary to an understanding of public affairs.

My next suggestion may seem beside the point and not applicable to this story. I believe, however, that auditors interested in municipal affairs must look at the human aspect of public problems. Politics and government are necessarily concerned with human relationship. They deal with persons, not things. Incidentally, one of the reasons why business men usually fail in politics is because they lack sympathy for the vast multitudes of people and fail to grasp the intimate human nature of public service. Furthermore, accountants themselves must take on a more human personality and not become as impersonal as adding machines.

Even accountants' mental approach to the municipal problem must be changed. They must not act on the assumption that every public officer is a rascal or an incompetent and that most of his acts are committed in bad faith. It is only fair to the man in public office to assume that he is intelligent, competent and honest until an audit of his record proves otherwise. If accountants will take this attitude their relations with their municipal clients will be improved.

STANDARDS NEEDED

Definite principles and standards of practice in the municipal accounting field have been sadly lacking. Accountants who wish to be of the greatest assistance to public bodies must assist in their development. Officers often hesitate to take one accountant's recommendations because another accountant may come

along later and make recommendations exactly opposite to the former's.

Accountants must agree upon the fundamental principles of municipal accounting and the terminology to be employed. The American Institute of Accountants is already contributing to this end by its active participation in the work of the National Committee on Municipal Accounting. Professor Lloyd Morey, who is chairman of your committee on governmental accounting, is vice chairman of the national committee. This group is making the first major effort to establish fundamental principles of municipal accounting. The central committee is composed of nine members, one representing each of the following associations:

American Association of University Instructors in Accounting

American Institute of Accountants

American Municipal Association

American Society of Certified Public Accountants

International City Managers' Association

Municipal Finance Officers' Association

National Association of Cost Accountants

National Association of State Auditors, Comptrollers and Treasurers

National Municipal League

The bureau of the census is also interested in a liaison capacity. Each organization represented has also a subcommittee on municipal or governmental accounting. Thus the entire group now consists of fifty-four persons. Since its organization in January of this year the committee has published *A Tentative Outline of the Principles of Municipal Accounting*, *A Bibliography of Municipal Accounting*, and *A Suggested Procedure for a Detailed Municipal Audit*. There is now in the hands of the committee for criticism a classification of municipal funds, assets and liabilities. Terminology is being developed by Professor Morey and Walter Mucklow with the aid of a special committee. The difficult task of formulating revenue and expenditure classifications is also under way. Forms of schedules for municipal financial reports will be prepared. The Institute's continued coöperation with the committee will be a distinct service to both accountants and municipalities.

The coöperation of accountants and public officers has taken a practical turn in Florida, also. The Florida League of Muni-

palities and the Florida Institute of Accountants are both interested in the development of uniform accounting and reporting. The two groups formerly worked independently and frequently at cross purposes. They were brought together through contacts with the National Committee on Municipal Accounting. The chairman of the municipal league's committee attended the excellent meeting of the Florida Institute of Accountants held in June, 1934. Working relations between the groups have been established and a joint committee of the league, the Institute, and the state auditing department has been formed. Surely this will bring more effective results than independent action. Public officers are like other human beings—they are more willing to use those things which they help develop than standards which they feel are imposed by outsiders.

AUDITING

Accountants may aid municipalities by developing better systems of audit. The ordinary investigation must be made more thoroughly. The resulting audit report, together with the letter of transmittal and audit certificate, should be unequivocal so that both the citizens and the public officers may know what has taken place. There should be audits of operating results based on cost accounting when it has been developed. There should be internal audits designed to reduce the cost of external audits. There should be examinations of the accounting systems of the municipality to determine whether or not they are adequate to provide all necessary information. Certainly the auditing field is the most common one in which accountants are engaged, and therefore their first efforts should be devoted to developing better audit procedures. However, I do not want to imply that officers should look upon accountants merely as auditors. As long as they do so the accountant's value to them will be limited.

Accountants interested in municipal audits will want *The Suggested Procedure for a Detailed Municipal Audit*, published by the National Committee on Municipal Accounting. This follows the same lines as the excellent publication, *Verification of Financial Statements*. The committee has recommended that in engaging auditing services, primary consideration be given to the qualifications of the auditors to perform a municipal audit and that preference be given to certified public accountants.

Perhaps the vicious custom of awarding municipal audit contracts to the lowest bidder, regardless of his qualifications, may be responsible for many unsatisfactory engagements—unsatisfactory to the accountant and to the municipality. The National Committee on Municipal Accounting disapproves the awarding of audit contracts on a competitive basis. The remedy for the bidding evil depends upon the further education of public officers to the requirements of an audit and upon the elimination of those accountants who take an engagement at a low price regardless of their own qualifications of the nature and extent of the work. Public officers must know what to expect from an audit and then retain auditors with professional pride, knowledge and experience.

The report must state clearly the facts disclosed by the audit. It should not flatter in order to obtain succeeding engagements, nor should it condemn for purely political purposes. Auditors should always maintain their independent professional position.

It might be well to consider having an oral audit report made to the governing body. Perhaps the outside auditor and the chief financial officer of the municipality might appear before the proper committee after due notice to citizens at large that such a hearing would be held. At this hearing both the citizens and the committee might question both the auditor and the chief financial officer. This would serve to restore public confidence by giving the impression that all the financial transactions of the public body were being made known without reservations. When citizens are properly informed of governmental activities they will vote more intelligently and will listen to fewer political stories which are circulated solely to get votes.

BOOKKEEPING NOT AUDITING

Public accountants should not attempt to carry out the duties of regularly appointed or elected public officers. To do so will only perpetuate incompetency in office and prevent the development and education of the men and women holding these positions. Accountants from the outside should not do the bookkeeping for a municipality and allege that they are thus conducting an audit. If they did they would be in the same class as the bookkeeping machine salesman who said that if he bought the machine, its work would constitute the audit and there would be no need for an outside auditor. Independent auditors should

insist that public officers prepare their own reports and balance their own records. If the accountants are sincerely interested in the improvement of municipal affairs, they must assist in the proper training of public officers by refraining from doing their work for them. Accountants have a big opportunity in public affairs, but they should not usurp the authority of the regular officers.

PERSONNEL

The type of person appointed to public office should concern the auditor. Physicians insist on professional men for health officers, and engineers demand engineers for engineering jobs. It therefore seems logical for the professional accounting societies to promote the appointment of properly qualified persons to municipal accounting and financial positions. No matter what standards of accounting exist, the work carried on can never rise above the intelligence and initiative of the officers who are appointed or elected to use them. There are particular difficulties in the smaller communities where it is scarcely possible to retain anyone with either professional standards or adequate training. This means, then, that accountants must devote themselves to promoting forms of government which will permit the employment of trained personnel. A foreign journal recently carried a statement by a high government officer that a municipality which could not afford to hire an engineer properly qualified to supervise its activities had no business to exist. Our American municipalities should give this thought some consideration.

Many well trained men, including certified public accountants, are already in public service. These men, who are elective or appointive state or local officers, are well qualified according to the accountants' own standards. They are frequently numbered among the key persons in their respective departments and are not affected by political upheavals. Certified public accountants hold the position of state auditor in Maryland and Texas and important positions in the cities of New York, Kansas City, Grand Rapids, Seattle and St. Paul.

The public service will not attract the kind of person needed in a technical position unless suitable compensation is provided. Accountants must assist in forming public opinion to this end. Each accountant must also see that his own community pays

salaries commensurate with the requirements of each accounting position. Within the last month the city auditor of a city of 125,000 population, a certified public accountant, resigned because his salary was only \$3,240 a year. Professional societies must carry the responsibility of filling public position with professional men.

REVENUES AND EXPENSES

Most of the discussions about municipal government concern either the cost of government or the raising of revenue. Until unit cost accounting can be developed, there will be little possibility of discussing governmental affairs on the basis of merit. Therefore, a vital factor in the improvement of local government is the development of proper cost-accounting methods. They are necessary for planning the budget and for comparing costs. It is now impossible to know whether or not activities of a particular government unit are performed at the lowest possible cost from period to period or with equal efficiency in different organization units of the same municipality. It is impossible to know whether a certain activity is carried on as economically in one municipality as in another. When it is possible to determine these facts, many misleading statements can be taken out of the discussion of municipal activities. If I were to make no other point I would like to stress this, namely, the necessity for the development of unit cost accounting for municipalities.

The question of revenue is the most pressing problem before local governments at the present time. Therefore, accountants who wish to act as financial advisers must study thoroughly the sources of municipal revenue. They must know the statutes of the states in which they operate and the limitations placed on the public bodies for the raising of revenue. They must also know what is being done in other states and other localities within the same state to obtain public revenues. They must have a thorough knowledge of economics and some idea as to how the cost of government should be distributed in accordance with available wealth and income. Of course, when one discusses tax matters he gets into the field of theory, and decisions on revenues will incline toward various social and economic philosophies. Some will contend that the revenues should come from an income tax; some, influenced from other sources, may contend that the sales tax is the only method of financing government. Out of all the

How Accountants Can Serve Municipalities

proposed methods accountants surely should be the group able to make some proper deductions as to who should pay the cost of government. Looking at the matter more narrowly, properly trained accountants can advise the municipality with regard to certain tax policy matters.

STATE, COUNTY, LOCAL RELATIONSHIPS

The financial relationship between county and municipal governments creates a serious situation. It is necessary for auditors and accountants to look carefully into these relationships in any engagement. In most states the counties either collect all taxes or collect delinquent taxes after the city has collected the current levies. An investigation of the records of the three thousand and more counties in the United States would disclose the fact that practically none of them sets up on its books as an asset the taxes placed in its hands for collection by the other local governments. Neither do counties set up on their records any liability to the other units. Therefore, it is frequently impossible for either party to know whether or not the money due and collected has been turned over. Any one who has made investigations of county offices will bear out this statement. Therefore, both for the sake of the profession and for the benefit of municipalities I urge accountants to insist that counties make proper accounting of money collected by them on behalf of other local governments.

Many state agencies are charged with the development, supervision and auditing of municipal accounts. As professional people accountants want to see that the accounting systems are developed and kept up to date and are not permitted to become mediocre or worse. Certainly they do not want standardization to mean merely standardized stupidity. They have a right to insist that the agencies charged with the supervision of local accounts maintain proper personnel with professional standards. In many cases, state departments and practising accountants may coöperate to mutual advantage. Unless men of training, vision, and ability work for the state, the accounting of all the local units in a state will be reduced to a low level. It may be to the interest of accountants to see that such state bodies carry out their duties aggressively. Accountants want no state agency to take from their hands work in which they are interested.

Let me say, on behalf of the state officers who conduct municipal audits, that they carry out well one phase of their work which

probably is minimized by some accountants. State bodies emphasize the legal aspects of the audit of receipts and disbursements. Perhaps sometimes they carry this point too far. However, if the professional accountants are going to compete with state agencies, they must know sufficient municipal law to be able to tell whether or not disbursements have been made legally. There will be much objection to this point, but if a disbursement is not legal, surely it is the auditors' duty to call it to the attention of the public body.

WAYS TO SERVE DIRECTLY

In the March, 1934, issue of THE JOURNAL OF ACCOUNTANCY, your official magazine, there appeared an article by G. Charles Hurdman, entitled "Unrecognized opportunities for public accountants in the municipal field." The first time I read this I was in serious disagreement with Mr. Hurdman and wrote him to that effect. In the preparation of this paper, I have read and reread this article. I now concede that Mr. Hurdman is substantially right, provided the accountants can prepare themselves for the services which he enumerates. Many of the matters which I discuss now were suggested by his paper. In general, he said that accountants could help with the development of budgets, both capital and current, the solution of debt problems, the assessment of property and public reporting.

First let me discuss one point on which I take issue with Mr. Hurdman. He says the public accountant, with his training in actuarial and financing matters generally, can do much to stabilize municipal credit by advocating the use of sinking funds for the retirement of bonds. This statement is contrary to general opinion of municipal finance experts and bond men who are now trying to prevent the issuance of sinking-fund bonds and to substitute serial bonds.

Hundreds of municipalities of various types are having difficulties with their debts. Many wish to avail themselves of the so-called "federal municipal bankruptcy act." Accountants have taken an interest in this and some have written to me to know how to make the necessary contacts to obtain engagements. Bond refunding is limited to accountants who have a broad knowledge of the bond market, economics, law and public affairs. The chief question at issue in the debt adjustments is the ability of a municipality to pay its debt at the present time

and at indeterminate dates in the future under indeterminate conditions. Most of the work of this kind, including the refunding of outstanding bonds, is being carried on, not by accountants, but by former municipal bond men. Such a job would probably be best accomplished by accountants, provided they had all the other qualifications which are necessary to carry on debt adjustments. However, I do not know of one case yet where outside accountants have been employed to handle such matters. This field presents opportunities at the present time.

Many accountants are specialists in departmental organization. Here they can be of material assistance to the municipality. They can suggest a type of organization for the entire financial function that will assure proper accounting procedure and control. They can also help to organize the work within the finance department and within the various bureaus or divisions of the department, so that it can be conducted in the most economical way and at the same time provide the basis for internal audits. If accountants are in general agreement that there should be a greater proportion of appointive officers, they may also work to this end, so that there may be no conflict, for example, between the elected treasurer and the appointed accounting or financial officer. They can also advocate the centralization of all authority for accounting and financial procedure.

We are now beginning to recognize the value of sound assessment of property for taxation. Certainly the assessment of personal property is a field for accountants. The factors entering into these assessments are largely accounting matters and therefore well within their realm. I doubt, however, if accountants are qualified to assess real property. It seems to me that this is the job of the engineer. If an audit of a municipality were thoroughly conducted, however, the auditors might be required to make a test check of the valuation placed upon certain properties. This certainly would be well within the scope of any investigation intended to disclose whether or not all of the public officers were conducting their activities without fear or favor. I believe that while the accountant may help to develop standards of assessing, the real job of assessing municipal property should be done by trained and impartial public officers. I do not want to minimize the necessity of good assessing. It is the foundation of the revenue system of our local governments, while they are financed principally from real-estate tax levies.

The field of public reporting offers an unusual opportunity for public accountants to show their originality and ability. Even the letter of transmittal with the formal report should be intelligible both to the officers of the public body and to the citizens at large. It should be clear and unequivocal. An accountant, in a recent letter to me, said, "Frankly, I question the possibility of preparing an accountant's audit report of a municipality that shall be understandable to the layman unless the layman has a reasonable foundation in the elements of government and of accounting." If this is true, I can see little value in having audits or reports made. Another accountant, however, has demonstrated the possibilities of public reporting by preparing for the newspaper in the city where he conducted an audit, a clear report of his findings written for popular consumption. In any case, how much good can an audit report be if it can be understood only by one or two persons in the municipal employment, and not by the balance of the officers or the public at large?

Accountants can be of service in matters related to the budget and to financial planning. For the current budget, however, the activities of the outside accountants should be directed more to the form of the budget than to the content and to the individual matters in it. They can convince the city council that the budget ought to be prepared on a basis which is reasonable and is adequately financed. They can suggest the form that the budget should take. They should not take part in the discussion of the detailed matters within the budget nor make decisions with respect to appropriations for various activities or departments. However, when they are engaged to make a special investigation, which would qualify them to advise on such matters, it would be proper to do so.

Accountants who are properly trained and have had a broad municipal experience could be called in to assist a municipality in preparing financial plans, financial program and financial policies. Financial planning would provide the best field for the broadly trained, experienced, municipal accountant. It certainly requires unusual knowledge and vision. Financial programs ought to be prepared for capital outlays for a long period of years. A financial program for the current year should be set up properly to make sure that no deficit will ensue. Many financial policies are also involved in the decision of the public bodies. There is a vast difference between one who is employed

merely to make an audit of municipal records and the accountant with broad training and knowledge who is in a position to act as adviser. The former is limited in his usefulness; the latter can serve in a broad and constructive manner.

CONCLUSION

Both private accountants and public officers have been looking at accounting and reporting too narrowly. Many of them think they have done their duty when their books are balanced. That step is essential, but it is only the beginning. The important thing is to prepare reports which will give information necessary for operating purposes. Too much emphasis has been placed on the mere form of accounting and bookkeeping. Mere figures must be translated into human action and into reports which are the basis of operating information for the administrative officers. Bookkeeping, accounting and auditing in themselves are of little use. They take on value only when they become the basis of action. When accountants have trained themselves so that they can take the figures from the records maintained by bookkeepers, translate these into helpful reports for the use of operating officers and administrative authority, and when they have been able to interpret these reports properly for the public, then accountants will be better able to serve cities. Municipalities need help. They are expecting guidance from accountants.

American Institute of Accountants

TRIAL BOARD

At the meeting of council of the American Institute of Accountants held October 15, 1934, at Chicago, Illinois, the committee on professional ethics presented a complaint against three members of the Institute, alleging violation of rule 2 of the rules of professional conduct.

The charges against one member were dismissed. The other two members were found guilty and were suspended from membership in the Institute for one month.

It was resolved that the names of the respondents be omitted in the publication of the report which, according to the by-laws, must appear in *THE JOURNAL OF ACCOUNTANCY*.

Complaint against a member of the Institute under the provisions of article V, section 4 (g) of the by-laws was presented by the committee on professional ethics.

After consideration of the complaint the member was suspended from membership in the Institute until May 1, 1935.

It was resolved that in publication of the report in *THE JOURNAL OF ACCOUNTANCY* the name of the respondent be omitted.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department*.]

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 15, 1934, 1.30 P. M. to 6.30 P. M.

Solve all problems.

No. 1 (25 points):

On January 1, 1933, the F company purchased 90% of the stock of Company G and 80% of the stock of Company H. Wishing to acquire the remaining stock of the more profitable company (Company H) Company F on June 30, 1933, disposed of 200 shares of its holdings in Company G at a price of \$160 per share, and on that date was successful in acquiring an additional 10% of the stock of Company H in exchange for the entire proceeds of the sale of Company G stock.

The investment accounts on the books of Company F are carried at cost except the account representing the investment in capital stock of Company G: this account has been credited with the proceeds of the 200 shares sold.

From the following post-closing trial balances of the three companies at December 31, 1933, prepare:

1. A consolidated balance-sheet
2. A statement of consolidated earned surplus
3. A statement of goodwill

	<i>Assets</i>		
	F	G	H
Current assets.....	\$152,500	\$150,000	\$105,000
Investment in subsidiary companies—			
Company G:			
Capital stock.....	220,000		
Advances.....	25,000		
Company H:			
Capital stock.....	214,000		
Advances.....	40,000		
Buildings and equipment.....		170,000	235,000
	<u>\$651,500</u>	<u>\$320,000</u>	<u>\$340,000</u>

	<i>Liabilities</i>		
Capital stock:			
Company F—3,000 shares.....	\$300,000		
Company G—2,000 shares.....		\$200,000	
Company H—1,000 shares.....			\$100,000
Due to parent company.....		25,000	40,000
Accounts payable.....	235,000	40,000	25,000
Surplus at beginning of year.....	166,500	60,000	145,000

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Profit for the year.....	* \$20,000	\$15,000	\$40,000
Dividends (paid Dec. 31, 1933).....	70,000	20,000	10,000
	<u>\$651,500</u>	<u>\$320,000</u>	<u>\$340,000</u>

* Dividends received from subsidiary companies, less expenses of parent company.

It is assumed that the profits of the companies for the year 1933 were divided equally between the two six months periods.

Solution:

Probably as good a start as any in the solution of this problem is to determine the cost of the investment in Companies G and H, as this information is necessary to compute the goodwill arising in the purchases.

An analysis of the investment account for the stock of Company G at December 31, 1933, would show:

	Shares	Amount
Balance, December 31, 1933.....	1,600	\$220,000
Sale price of stock sold.....	200	32,000
Cost of original purchase (90%).....	1,800	\$252,000
Cost per share ($\$252,000 \div 1,800$).....		<u>\$140</u>

The 200 shares of stock of Company G cost the F company \$28,000 (200 times \$140), which amount should have been credited to the investment account, rather than the selling price of \$32,000. The adjustment necessary to reflect the correct cost in the investment account and to transfer the realized profit to the surplus account follows:

Investment in Company G.....	\$4,000	
Surplus (F company).....		\$4,000
To transfer the profit on the sale of 200 shares of stock of Company G to the surplus account		

After the investment account has been charged with the \$4,000 debit in the above entry, it will show that the cost of the 1,600 shares held on December 31, 1933, cost (1,600 times \$140) \$224,000. (Since the F company is following the practice of carrying its investments at cost and taking subsidiaries' profits into income when they are realized in the form of dividends, a share of Company G's profits for the six months ended June 30, 1933, has not been added to the cost of the stock sold in computing the profit on the sale. Correspondingly, in taking up F company's share of G's profit for 1933, no consideration is given to the profit applicable to the stock sold. This profit was in effect realized by the sale of the stock, and forms part (\$750) of the \$4,000 profit.)

The cost of the two purchases of the capital stock of Company H is determined in the following analysis of the investment account:

	Shares	Amount
Cost of first purchase.....	800	\$182,000
Cost of second purchase.....	100	32,000
Total.....	900	<u>\$214,000</u>

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Having obtained the cost of the several purchases of stock in the subsidiaries, the candidate may now proceed with the statement of goodwill. It will be noticed in the following statement, and in the consolidated balance-sheet, that the goodwill arising from the second purchase of stock of Company H is deducted from the surplus arising from the first purchase ("negative goodwill"). Whether the remaining, or net "negative goodwill" should be applied against the goodwill arising from the purchase of the stock of Company G is open to question.

- (3) The F Company and its subsidiaries, Companies G and H. Statement showing computation of goodwill (and surplus arising from consolidation), December 31, 1933

	Book value		Goodwill (surplus arising from consolidation*)	
	Total	Proportionate interest	Cost of stock purchased	
<i>Acquisition of stock of Company G:</i>				
Book value—January 1, 1933:				
Capital stock.....	\$200,000			
Surplus.....	60,000			
Total.....	<u>\$260,000</u>			
80% thereof.....		<u>\$208,000</u>	<u>\$224,000</u>	<u>\$ 16,000</u>
<i>Acquisition of stock of Company H:</i>				
First purchase: January 1, 1933:				
Net worth:				
Capital stock.....	\$100,000			
Surplus.....	145,000			
Total—January 1, 1933..	<u>\$245,000</u>			
80% thereof.....		<u>\$196,000</u>	<u>\$182,000</u>	<u>\$14,000*</u>
Second purchase, June 30, 1933:				
Profit for the six months January 1, 1933 to June 30, 1933.....	20,000			
Total, June 30, 1933.....	<u>\$265,000</u>			
10% thereof.....		<u>26,500</u>	<u>32,000</u>	<u>5,500</u>
Totals.....		<u>\$222,500</u>	<u>\$214,000</u>	<u>\$8,500*</u>

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(2) The F Company and its subsidiaries, Companies G and H. Statement
of consolidated surplus for the year ended December 31, 1933

Company F:

Balance, January 1, 1933.....		\$166,500	
Dividends received:			
Company G (80% of \$20,000).....	\$16,000		
Company H (90% of \$10,000).....	9,000	25,000	
Profit on sale of stock of Company G....	<u> </u>	<u>4,000</u>	\$195,500

Deduct:

Net loss for the year (exclusive of the dividends received from subsidiary companies).....	\$ 5,000		
Dividends paid, December 31, 1933.....	<u>70,000</u>	<u>75,000</u>	
Balance, December 31, 1933.....			\$120,500

Company G:

Pro-rata share of the net decrease in the surplus account of Company G during the year:			
Dividends paid.....	\$ 20,000		
Profits for the year.....	<u>15,000</u>		
Net decrease in surplus account....	<u>\$5,000</u>		
80% thereof.....			4,000

Company H:

Pro-rata share of the net increase in the surplus account of Company H during the year:			
Six months ended June 30, 1933.....	<u>\$20,000</u>		
80% thereof.....		\$ 16,000	
Six months ended December 31, 1933..	<u>\$20,000</u>		
Dividends paid.....	<u>10,000</u>		
Net increase.....	<u>\$10,000</u>		
90% thereof.....		<u>9,000</u>	<u>25,000</u>
Consolidated surplus, December 31, 1933..			<u>\$141,500</u>

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The following consolidated balance-sheet was prepared by totaling the current assets, buildings and equipment, and accounts payable accounts; by eliminating the reciprocal accounts; and by inserting the goodwill, surplus arising through consolidation, minority interests, and consolidated surplus as derived in the accompanying statements and schedules. The formal working papers shown on page 60 are unnecessary to the solution, and are given here for explanatory purposes only.

- (1) The F Company and its subsidiaries, Companies G and H. Consolidated balance-sheet, December 31, 1933

<i>Assets</i>	
Current assets.	\$407,500
Buildings and equipment.	405,000
Goodwill arising through consolidation.	16,000
	<u>\$828,500</u>
<i>Liabilities and capital</i>	
Accounts payable.	\$300,000
Minority interests:	
Company G.	\$ 51,000
Company H.	27,500
	<u>78,500</u>
Capital:	
Capital stock—3,000 shares.	\$300,000
Surplus.	141,500
Surplus arising through consolidation.	8,500
	<u>450,000</u>
	<u>\$828,500</u>

The minority interest in the subsidiary companies was determined by multiplying the book value of the companies at December 31, 1933, by the percentage of minority interest, as follows:

	Companies	
	G	H
Capital stock.	\$200,000	\$100,000
Surplus, January 1, 1933.	60,000	145,000
Profit for the year.	15,000	40,000
Dividends paid.	20,000*	10,000
	<u>\$255,000</u>	<u>\$275,000</u>
Book values, December 31, 1933.		
Minority interest:		
Percentage.	20%	10%
	<u>20%</u>	<u>10%</u>
Amount.	\$ 51,000	\$ 27,500

The F Company and its subsidiaries, Companies G and H. Consolidated balance-sheet—working papers, December 31, 1933

	F	G	H	Eliminations and adjustments	Consoli- dated balance- sheet
Assets					
Current assets.....	\$152,500	\$150,000			\$407,500
Investment in subsidiary companies—					
Company G:					
Capital stock.....	220,000			(1) \$ 4,000 (2) \$208,000	16,000 Goodwill
Advances.....	25,000			(6) 25,000	
Company H:					
Capital stock.....	214,000			(3) 222,500	8,500 Surplus arising from consolidation
Advances.....	40,000			(6) 40,000	
Buildings and equipment.....		170,000	235,000		405,000
Totals.....	<u>\$651,500</u>	<u>\$320,000</u>	<u>\$340,000</u>		<u>\$820,000</u>
Liabilities					
Capital stock:					
Company F—3,000 shares.....	\$300,000				\$300,000
Company G—2,000 shares.....		\$200,000	(2) 160,000		40,000 Minority interest
Company H—1,000 shares.....			(3) 90,000		10,000 "
Due to parent company.....		25,000	(4) 40,000 (5) 65,000		
Accounts payable.....	235,000	40,000	25,000		300,000
Surplus at beginning of year:					
Company F.....	166,500			(1) 4,000	170,500 Surplus
Company G.....		60,000	(2) 48,000		12,000 Minority interest
Company H.....			(3) 130,500		14,500 "
Profit for the year:					
Company F.....	20,000		(4) 4,000 (5) 25,000		41,000 Surplus
Company G.....		15,000	(4) 12,000		3,000 Minority interest
Company H.....			(3) 2,000		4,000 "
Dividends (paid December 31, 1933):			(5) 34,000		
Company F.....	70,000			(4) 16,000	70,000 Surplus
Company G.....		20,000		(5) 9,000	4,000 Minority interest
Company H.....			10,000		1,000 "
Totals.....	<u>\$651,500</u>	<u>\$320,000</u>	<u>\$340,000</u>	<u>\$549,500</u>	<u>\$820,000</u>

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Adjusting and elimination entries used in the working papers.

(1)

Investment—Company G	\$ 4,000	
Surplus—Company F		\$ 4,000
To record the profit on the sale of 200 shares of stock of Company G		

(2)

Capital stock—Company G	160,000	
Surplus at beginning of year—Company G	48,000	
Investment—Company G		208,000
To eliminate the 80% interest in the capital stock and surplus of Company G as at the date of purchase.		

(3)

Capital stock—Company H	90,000	
Surplus at beginning of year—Company H	130,500	
Profit for the year—Company H	2,000	
Investment—Company H		222,500
To eliminate the 90% interest in the capital stock and surplus accounts of Company H, and the 10% interest in the profits for the first six months of 1933. (The latter representing part of the surplus at acquisition of the 10% purchased on June 30.)		

(4)

Profit for the year—Company F	4,000	
Profit for the year—Company G	12,000	
Dividends—Company G		16,000
To transfer to the profits account of Company F its 80% interest in the profits and dividends of Company G.		

(5)

Profit for the year—Company H	34,000	
Dividends—Company H		9,000
Profit for the year—Company F		25,000
To transfer to the profits account of Company F its 90% interest in the dividend of Company H, and its share of the earnings of the latter company for the current year as follows.		

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	Six months ended	
	June 30	Dec. 31
Profit	\$20,000	\$20,000
Per cent.....	80%	90%
Share	\$16,000	\$18,000

	(6)	
Due to parent company		\$65,000
Advances—Company G		\$25,000
Advances—Company H		40,000
To eliminate the inter-company accounts.		

Correspondence

UNIFORM ACCOUNTING FOR INDUSTRY

SIR: One must be bold to venture to add to the masterly treatment of the problem of uniform accounting for industry presented so eloquently by Mr. Couchman in the address published in the November, 1934, issue of *THE JOURNAL OF ACCOUNTANCY*. This problem of the accountancy profession finds its prototype in that of the legal profession in its attempted restatement of the law. An analogy between the two may prove of interest to your readers.

The American Law Institute was organized in February, 1923, and set before itself the task of preparing a restatement of the principles of the common law. Significant is it to note that the movement originated with and is being executed by the legal profession itself. It has not come as a mandate from government. It is no attempt to compile an official code to be imposed upon the public and the profession. Voluntarily, the nation's ablest legal minds have been dedicated to these labors.

What progress has this great enterprise achieved? The principles of the common law have been in process of formulation for centuries. The average lay mind would imagine that those principles have become thoroughly crystallized and fully developed and that a restatement of them would be a task simply and expeditiously accomplished. Yet today, after more than eleven years of unremitting labor, only two subjects (contracts and agency) and a portion of a third (torts) have been published; many others, however, are well in progress.

The difficulties encountered have been manifold. Addressing the American Law Institute at its third annual meeting, May 1, 1925, Justice Cardozo (now of the United States supreme court, then chief judge of the court of appeals of New York and actively identified with the work of the restatement) said:

"The existence of this institute is a declaration to the world that 'laissez faire' in law is going or has gone the way of 'laissez faire' in economics. . . .

"One finds it hard to exaggerate the difficulties that have been met and overcome. . . . At the beginning there has been need to gather from the pronouncements of the courts the principle or the rule implicit in their judgments. . . . This in itself is a wearisome and poignant task. . . . You choose after long debate the principle or the rule that you are ready to espouse, and you think you understand it. There lies before you still the task of expressing it in words. At once new vistas of uncertainty are opened to your gaze."

The judge then proceeded to elaborate on the many difficulties of the task, presenting specific illustrations. To select one, speaking on the subject of torts, he said:

"When I heard that the subjects to be covered at the beginning were battery, assault and false imprisonment, I thought there would be easy travel. I ask you to take my word for it—we have met with hard roads, and worse passes are ahead. A blow in the face seems a fairly palpable fact, but all sorts of mental reservations and concomitants have to be known and estimated before you can determine whether it is to be reckoned as an actionable wrong."

Finally, when a particular subject of the restatement is completed, what authority does it have? And, more especially, what finality does it have? In publishing each volume, the institute makes clear that the restatement has only the authority of the institute; that it represents the best legal thought as to what is the present state of the law on the subject; that it provides merely a new starting-point for future development. As to finality, Justice Cardozo phrases it thus:

"I am speaking of the magisterial pronouncements of the restatements themselves. In these, let us give definiteness and fixity of outline where there is definiteness and fixity in the law as it exists or where argument so preponderates that a choice is fairly safe. Let us not hesitate, however, in other situations to say in all frankness that the problem is yet unsolved, and while indicating competing considerations either way, leave the answer to the years."
". . . definiteness and assurance and finality must be left to the agency of time . . . that in determining the tendencies and directions of legal development in the future, something will have to be left, even when the restatement is completed, to those tentative gropings, those cautious experiments, those provisional hypotheses, that are part of the judicial process."

Thus, when this great restatement of the principles of the law is ultimately completed, it will be only a beginning. Change will set in before the ink is dry. It will constitute a consolidation and condensation of the learning of yesterday, preparing the legal profession for the developments of tomorrow.

Mr. Couchman's discussion of the principles of accountancy singularly parallels Justice Cardozo's analysis of the legal principles. Accounting principles are grouped by Mr. Couchman in three classes: those that are now generally accepted, those that are at present debatable, and those as yet hidden, unknown or unstated. "Any strait-jacket applied to this growing art would stunt future development and improvement." "May it not be similarly true that a rigid system devised and enforced today would be equally unsuited for the industry of tomorrow?" Cardozo, in another treatise, has said the like of law. Common to the two professions, law and accountancy, has been the struggle between stability and progress, between flexibility and certainty.

But the proponents of uniform accounting for industry propose to go much farther in accountancy than the restatement has in law. As Mr. Couchman points out (page 336), there are four factors concerned: principles, procedure, accounts and presentation. The restatement of the law is limited to the principles of the common law. Points of procedure and presentation are not at all attempted. And if the difficulties are so great in arriving at a common agreement as to principles, how infinite would be the obstacles to uniformity of procedure and of presentation?

Unhappily, recognition of the analogy between the legal and accountancy professions is not as general as it should be. Too many still believe (and this number includes many judges, lawyers, legislators and administrative officers) that accountancy is an exact science—that an accounting principle is comparable to a mathematical formula. Too few recognize the truth that Mr. Couchman stresses, that the practice of accountancy involves the exercise of experienced judgment and skilled opinion, and that that is its major characteristic, not a purely incidental one.

The obstacles to uniform accounting for industry (embracing principles, procedure, and presentation) are more insuperable than those encountered by

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the American Law Institute in its restatement of the law. To seek to attain uniformity of accounting by mandate of government (either legislative or administrative) would be a fatal blunder, disastrous alike both to the public and to the profession. As Mr. Couchman suggests, and as is pointed out by the precedent of the legal profession, the solution rests rather with gradual evolution within the accountancy profession itself.

Yours truly,

LOUIS S. GOLDBERG

Sioux City, Iowa, November 10, 1934.

Book Reviews

THE FINANCIAL POLICY OF CORPORATIONS, by ARTHUR STONE
DEWING, *Ronald Press Company*, New York. 1309 pages. 1934.

In the preface of the third edition of *The Financial Policy of Corporations* Mr. Dewing states that: "Although this edition is called a revision it is, in all important respects, a new book." It may be ungracious to take issue with the author on his own statements, but certainly in those features which are particularly interesting to accountants there is little change from the views and material included in the former edition. Of the three factors which there is every reason to believe will have a determining effect on financial policies of corporations in the future little is said, and that little is so vague and general as to be of small value as a guide in determining or anticipating the future policies of corporations.

The first of these factors is the federal securities act which is given four or five pages of text and a few scattering references throughout the volume. One would certainly expect in a work of this sort a full analysis of the act, some considered statement as to its effect in withholding the flow of investment funds from their legitimate channels and some expression of views as to what revision is necessary in the act and what features of it are of permanent value. We find nothing but vague and brief suggestions upon these points. With the vast reservoirs of material at the command of the author, with his broad experience in corporate finance and with his clarity of perception and lucidity of style we might certainly expect more than this.

The second important factor with which everyone responsible for or interested in corporation finance must deal in the near future is the devaluation of the dollar and the subsequent abrogation of the "gold clause" in bonds. Mr. Dewing makes only the briefest reference to this and does not seem to think the violation of the contract with the bondholders and the accompanying uncompensated transfer of interest in the property from the money creditors to the holders of equities is a very serious matter. A statement from a man of the author's experience and eminence on the effect of governmental interference with private contracts on future financing would be of much significance.

The third factor which has affected most corporations of any size is the government regulation of stock exchanges and, closely allied with this, the recent fairly successful attempts of stock exchanges to improve corporate practices in reporting to stockholders and in the adoption of more nearly accurate accounting principles and methods. Certainly the men directly responsible for the financial policies of corporations have been much occupied with the aims and requirements of the stock exchanges in the eight years which have elapsed between the two editions of Mr. Dewing's book.

In the previous edition exception was taken to many corporate practices in presenting reports to stockholders. No one would pretend that corporate reports at present are perfect, but it is equally impossible to deny the substantial improvement that has been made in the last few years. Mr. Dewing, however, does not seem to think this movement is of sufficient significance to be noticed, and he apparently does not think the work of the securities and

exchange commission will have much bearing on the financial policy of corporations.

By the omission of these things the principal value of his work is reduced to the historical and here it is of real importance. The large volume of material is presented in a clear and interesting manner. It is well organized and the examples are pertinent, interesting and frequently amusing. With many of the author's views it is impossible to disagree. However, his treatment of accounting theory and practice, which occupies the greater part of book IV, is such that it seems impossible that any practising accountant of experience and standing could agree with him.

We find on page 497 these "postulates"—“(1) that there can be a money value fixed to correspond with every economic value; (2) that this fixed money value changes in a definite and determinable ratio in accordance with changes in the corresponding economic value; (3) that any one economic value in a series of changes may be represented by the corresponding money value.” No matter what parts of the book are new, these are word for word as they stand in the previous edition.

The author's curious views, expressed with a vigor and clarity equalled only by their inherent error, have not altered with the years but have rather strengthened. He still ignores the basic concepts of accountancy: that financial rather than economic or physical facts are to be recorded and that the receipt or expenditure of money or the realization of assets in terms of money or the imminent probability of these things is the stuff of accountancy rather than changes in "value" of some sort, measured by some undetermined scale and revised with confusing frequency. The author complains that accountancy is not an "exact science" and "the accountant does not tell the business man what to do." It is hardly possible that the author is seriously proposing to shape business policies and transactions to fit the accounts rather than to adopt the accounts to transactions—but if that is not his meaning it is difficult to deduce another.

To the accusations of being a "pragmatic science" (page 495) accountancy can do nothing but plead guilty, but in this pleading every science based on human actions and emotions must join. Accountancy deals first with persons and with things only as they are owned by, owed to or used for the benefit of persons. They are represented by what persons have paid or will pay for them.

Perhaps the "pragmatic science" most closely related to accountancy is law. Sir Henry Maine in his book *Ancient Law*, says of primitive law: "Law has scarcely reached the footing of custom, it is, rather a habit." The whole fabric of the law is built on this and scientific jurisprudence is a series of principles deduced from the mass of custom and habit which formed the primitive unwritten law. The conception of a primordial and divinely ordained code, while a useful basis on which to enforce obedience, has no warrant from an historical point of view.

Accountancy, in its sphere, has done for business some of the same things which law has done for the community at large. It has provided reasonably consistent and uniform methods of describing transactions, in themselves not always consistent, and has provided for a record of transactions and their results, expressed in conventional units and by conventional means. It is folly, and dangerous folly, to attempt more.

All attempts to inject into accounts conceptions of "value" not supported by transactions, actual or to be consummated in the near future, open the way to manipulation and deceit and deprive the investor of any solid basis for his conclusions. Closely bound up with this is the author's conception of the income account as "dynamic" and the balance-sheet as "static." The balance-sheet is a chronological record of investment in the same way that an income account is a chronological record of earnings. One is no more "static" than the other.

Enough has been said to show that Mr. Dewing's views are no more like the usual concepts of accountancy now than they were in 1926. As accountants can not now do what Mr. Dewing desires any more than they could when the earlier editions appeared, his opinion of them has not improved.

While this book may not be of the greatest value to corporation executives and accountants who are faced with immediate problems of corporate finance it does, nevertheless, provide part of the background which anyone responsible for the finances of corporations should have and it provides it in a manner which is clear, interesting and authoritative.

MAURICE E. PELOUBET

BEFOERDERUNGS—UNTERNEHMUNGEN ZUR SEE, by OTTO REUTHER. *C. C. Poeschel Verlag, Stuttgart.* 233 pages. 1933.

Accountants interested in ocean shipping and in a more intimate knowledge of the industry than can be gathered through the usual audit procedure will find *Befoerderungs—Unternehmungen Zur See* very useful. One is impressed by the thoroughness with which the subject has been treated. All aspects of importance are dealt with broadly and comprehensibly.

The opening chapter is purely introductory. Characteristically it starts with a definition of terms. Thereupon it deals with the position of ocean shipping in relation to other forms of transportation with its international competitive character and with the resulting special types of organization ranging from single-vessel ownership to the modern giant enterprises. It shows the conflicting political interests of the national government against the financial interests of the lines themselves and stresses the differences between ocean and rail shipping under government control.

Very readable chapters on sailing vessels, freight and passenger steamers follow the general introduction. Apparently the sailing vessel still remains an important factor in long-distance mass transport and as a training school for seamen. The relative advantages of size and speed are discussed; problems of construction, interior division and arrangement, machinery and fuel, loading and unloading questions are considered. Size, speed, luxurious interior and general demands for safety and comfort in passenger vessels, the élite among ocean steamers, place them in a special class.

The next chapters deal with the authority and responsibilities of various personnel groups, their care, pay and organization. Considerable space is given to the catering problem. Then follow treatises on navigation; harbors and their facilities; subsidiary activities such as towing, trucking, stowing, warehousing, delivery, ship-chandlery, etc.; admiralty law including interesting paragraphs on signaling and the use of the flag; classification and insurance.

This completes the first part of the book.

Book Reviews

Part II deals principally with finance, accounting and management. It commences with a general discussion of capital requirements and returns, relations between the investment in floating and other equipment and between fixed and working capital.

A chapter on depreciation sets forth the difference between actual and service life of the various types of vessels and of vessels in different kinds of service, the effect of extensive repairs, obsolescence and the writing down of book values to nominal amounts. Rational conclusions are drawn, in substance admitting that the cost of a vessel should be written off proportionally over the years of its useful life, the periodical provisions being a part of the vessel's operating cost. The author does overlook the additional need for frequent overhauls and reconditionings and the merits of supplementing the regular depreciation policy by extra provisions as warranted by the profits. The conflicting views of the tax collector are presented and the effect of exchange fluctuations is described.

Other chapters include a classification of operating accounts, the temporary character of which is acknowledged by the author. Powerful arguments are brought forth against the inclusion of interest in the operating costs. The various expenses and revenues are examined in considerable detail. The balance-sheet and profit-and-loss statement, voyage accounts, budgeting and rate making receive their full share of critical observation. The last twenty pages deal with general policy, forms of organization and conditions in the business. At the end a list of available literature is given.

The general accounting principles set forth are sound, but they shed no new light upon any of the important controversial questions. The great merit of the book to the profession lies in its comprehensive treatment of a subject that must be of considerable interest to a number of practitioners.

A. VAN OSS

DE LEER VAN HET BOEKHOUDEN, by O. TEN HAVE. *J. Waltman, Jr.*, Delft, Netherlands. 305 pages.

De Leer Van Het Boekhouden deals almost exclusively with bookkeeping in the Netherlands during the 17th and 18th centuries. The opening chapter gives an historical survey of the general industrial development and of certain trade customs and business methods in the Low Countries from their ascendancy culminating in the 17th century to their swift decay in the 18th. The second chapter takes up more than one half of the book. It gives the history of bookkeeping and of methods of instruction in the art and is for the greater part devoted to the Dutch authors on the subject, the books written by them and specific cases in those books.

A few pages follow on the literature of these days in other countries. The quotation from an English source, "Holland was the training school not only of many of our own writers, but of our merchants," is significant of the prominent position of the Low Countries in accountancy, commerce and finance and recognizes the extent to which they were a leading factor in the development of the art in the 17th and 18th centuries.

Chapter IV reviews the material of the preceding parts. The gradual segregation of accounts into different groups such as personal, nominal, proprietary and other accounts; the emergence of general rules for debiting and crediting;

expansion of trial balances into balance-sheets; subdivision of the journal; quantitative inventory control; single entry; prevailing industrial accounting; etc. are briefly discussed and the contemporary record of various kinds of transactions is shown.

Several appendices are annexed. The first give descriptions and studies of material found in Dutch archives and libraries. A list of sources, an index and some very interesting reproductions of title pages, a page of a journal kept in 1589 and a closing trial balance of the year 1600 add to the usefulness of the book to those who are interested in the subject.

A. VAN OSS

FINANCIAL ORGANIZATION AND ADMINISTRATION, by W. MACKENZIE STEVENS, *American Book Company*, New York. Cloth, 670 pages. 1934.

Once in a blue moon a "damned professor" produces a book which makes practical business men and accountants sit up and take notice! Such a book is Dr. Stevens' *Financial Organization and Administration*, in which we have an intensely practical guide for the young business man—and for many an oldster, for that matter—on how to organize a business, how to raise capital in the most advantageous way, how to avoid the pitfalls of over- and under-capitalism, how to foresee and prepare for business cycles, and generally how to administer effectively the financial and operative affairs of a going business. I confess I took up the book with some reluctance. The country's experience with academic theorists has not filled me with enthusiastic admiration for college professors in business, and the flood of books on the new economics led me to expect just another "ism." But here is a writer with both feet on the ground who knows from long experience in various capacities how business is managed—and mis-managed—and writes vigorously and clearly of what he knows. Withal a sense of humor and a keen wit pervade his pages, as, e.g., in his good-humored, cynical advice on what to do in case of monetary inflation:

"If the financial manager believes that inflationists will reach their objectives, practically all the principles of effective financial management must give way to one, viz.: convert all assets into residual equity claims on as much physical property or commodities as it is possible to procure; and convert all possible liabilities to others than yourself into liabilities payable in fixed numbers of dollars. Thereafter your creditors and investors must take payment in depreciated currency at the nominal rates prescribed in the contract, while the commodities and property you hold rise to their real value. By this means the property of others is conveniently and legally transferred to you. The mutuality of interest between competent corporate managements, stockholders, investors and employees is destroyed by such a process, of course. But it is the essence of monetary inflation to take property by law from those who have claims stated in specified numbers of dollars and to give this property to those who have the residual or equity interests. Ordinary rules of good business no longer apply. By law, every man is encouraged to grab as much and as soon as he can at the expense of his neighbor, his employees, his investors and those who supply him with goods. Under such conditions the business man will profit most who operates his business as a speculative enterprise" (p. 396).

The book is divided into three major parts. Part one (chapters I–XI) deals with financial organization giving descriptions of all types with their comparative advantages and disadvantages. A significant chapter is the one on

reorganization of a failed business, a matter upon which many a public accountant may be called for advice in these days. Most of this part is devoted naturally to corporate forms of organization, including an instructive chapter on capitalization.

In part two the author explains the different ways of procuring capital, whether by borrowing, selling stock or self-financing, with useful hints as to the best methods for a new business. Where to incorporate is the subject of an interesting discussion (chapter XVI), and the final chapter XVII of this part, "Public regulation of the sale of securities," is a rather startling revelation of liabilities that may be incurred unwittingly by incorporating in certain "blue-sky-law" states. And yet, in the opinion of Dr. Stevens, the innumerable exemptions provided in most of the blue-sky laws practically nullify the purpose of the acts to prevent stock swindles while placing a heavy and unnecessary burden on honest promoters. He gives two pages to a list of the fees and expenses which may be imposed in certain states with the closing sage comment, "In some cases, the amount of capital necessary to get permission to sell stock would be sufficient to start the business if such complicated and expensive permission were unnecessary" (p. 321). Aside from this burden, which might be plausibly defended as being for the public welfare, the author's further conclusion is sound—"The paternalism attempted is impracticable—if our population is to be treated by our legislators like children, the securities commission is certainly not a very satisfactory parent" (p. 333). Necessarily this chapter is short—a full treatment of the blue-sky laws, including the federal securities act of 1933, needs a book by itself, which Dr. Stevens promises in the near future. It will be welcomed by public accountants at least.

Part three (chapters XVIII–XXV) which makes a good half of the book, covers exhaustively financial administration based on budgetary control. In fact, by itself it is a treatise on the science and art of budgeting and forecasting, well illustrated by tables and graphic charts—a good workmanlike job. In the light of recent government activities and plans, pessimistic readers may consider superfluous the last chapter on surplus and reserves, but at least it rounds up the book with the traditional happy ending dear to American optimists!

Painfully aware of how inadequate is this brief review of a really notable book, I must fall back on the customary reviewer's tag—the book must be read to be appreciated. Nevertheless I am sure no reader will regret the time he gives to it.

W. H. LAWTON

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

EARNED SURPLUS AFTER DECLARATION OF STOCK DIVIDEND

Question: A corporation, in 1922, capitalized \$20,000,000 of its earned surplus by the declaration of a stock dividend. Since that date operating losses have created a deficit of about \$5,000,000. It now proposes to reduce the par value of its capital stock by \$20,000,000. After consummation of the latter transaction what is the earned surplus considered to be and how should the surplus accounts be stated on the balance-sheet?

Answer No. 1: We would say that at first thought it would seem that the proposed reduction of the par value of capital stock by \$20,000,000 would restore that amount of earned surplus, leaving \$15,000,000 available for dividends. Such is not the case. The effect of the declaration of a dividend, even of a stock dividend, is not to be so lightly set aside. The \$20,000,000 of stock dividend taken out of earned surplus has removed that sum just as effectively and permanently as though a cash dividend in the same amount had been declared. It can not now be restored to earned surplus by any action of the corporation or of its directors.

The proposed reduction of the par value of the capital stock will create a capital surplus. If a dividend may be declared legally from such surplus the stockholders should be advised as to the source from which it is paid, lest they be led to believe that it is being paid out of earnings.

Accordingly, the surplus when created should be earmarked as "surplus arising from reduction of par value of capital stock." The deficit should not be absorbed in it for balance-sheet purposes, but, on the contrary, both the new surplus and the deficit should be stated specifically, unless subsequent results of operations carried to earned surplus or deficit be earmarked by describing such account on the balance sheet as: "Earned surplus or deficit from January 1, 1934."

ASSIGNMENT OF NOTE PAYABLE ON BALANCE-SHEET

Question: I have a corporation as a client the majority of whose stock is owned by one individual. The corporation also owes this individual \$75,000 in the form of a note. The corporation also owes the local bank \$30,000,

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which note has been endorsed by the principal owner, and a further considerable amount is owed to trade creditors. The local bank has taken an assignment of the note due the owner of the company as additional security for their loan.

I have put a footnote on the balance-sheet to the effect that the bank is secured by an assignment of this note, and both my client and the bank criticize handling the matter in this way. Neither feels that it is an item which should appear on the report in any way. I feel that it constitutes a preference and should be commented upon.

Answer No. 1: A is a corporation indebted under notes payable to B, the owner of the business, and to C, a lending bank. D represents other unsecured creditors.

It is stated that B has endorsed A's note to C and also has assigned to C the note due B from A. It is stated, furthermore, that both B and C object to the disclosure of the aforementioned assignment by a footnote in the balance-sheet of A.

In our opinion, the assignment need not be disclosed. The situation must be viewed in the light of the interests of the four parties aforementioned. One should seek to avoid the concealment of any material fact, but it must be borne in mind that the balance-sheet in question is that of the corporation A. While the fiduciary relationship of the principal stockholder of the corporation distinguishes him from other creditors, he is, nevertheless, a creditor as well as a stockholder. One may assume that the indebtedness of the corporation to him has arisen normally and is not in fact capital. (Promises to other creditors of the corporation by the principal stockholders proposing to subordinate his position as a creditor to that of other creditors would result in impounding such debt as effective capital.)

The assignment referred to in the instant case differs intrinsically from a transaction whereby an asset belonging to the corporation is pledged. The assignment of the note payable involves an agreement which is distinctly separate and apart from any relationship existing between the corporation and its general creditors in so far as the ultimate payment of such creditors depends upon the realization of the assets of the corporation.

Were one to insist upon the disclosure of the assignment in question the next step would be to require the disclosure of the endorsement. Both of these are simply collateral facts which imply that the bank does not consider the corporation a good risk on an unsecured basis. Followed through to absurdity, one should for the same reason disclose similar facts, for example: that certain ordinary creditors have required the personal guarantee of the principal stockholders before extending credit to the corporation. The accountant could not object to such disclosures, but his duty is limited to the disclosure of material fact inherent to the balance-sheet which is the subject of his report.

Answer No. 2: We can well imagine that a creditor and a heavy stockholder might each consider the company's note in a different light, and we therefore believe inasmuch as the auditor is aware of the assignment, that he should have a footnote on the balance-sheet mentioning it.

STOCK OF SUBSIDIARY ON BALANCE-SHEET OF PARENT COMPANY

Question: Corporation "A", no par value, capital \$5,000,000 has a wholly owned subsidiary which we will call corporation "B".

Corporation "B" holds stock and securities in other companies domestic and foreign including the stock of corporation "A".

Corporation "A" buys the stock of "B" and corporation "B" buys the stock of corporation "A" therefore "A" through its ownership of "B" is buying its own stock and it should be noted that corporation "A" has no surplus but has liquid funds and comparatively small debts to general creditors.

The question is: Should we show on the balance-sheet of corporation "A" merely the cost of its stock in corporation "B" or should we show on the face of "A" balance-sheet that it owns its own stock? The only method that occurs at this writing is to earmark the wholly owned subsidiary stock on the balance-sheet of the parent company, "A", by saying "B" corporation stock including so many shares of corporation "A". This would be an incomplete showing objectionable to the management although it would give notice of the number of shares held through the subsidiary.

One other question would be as to whether the wholly owned subsidiary could be included in the item of stocks and bonds of other companies or stated separately as being wholly owned.

The "A" corporation stock is not now listed on any exchange. The management who hold the majority of the "A" corporation stock would prefer to simply say stocks and bonds of other companies, although their responsibility must be met not alone to stockholders but to banks and other creditors including federal reserve banks.

Answer No. 1: It is our opinion from the facts submitted that a consolidated balance-sheet should be prepared of company A and its wholly owned subsidiary company B, the latter company's holdings of the parent company's stock thus being treated as treasury stock and described as A's stock held by subsidiary.

If, however, a consolidated balance-sheet be not prepared, even though such a presentation seems proper, then we suggest that the "legal" balance-sheet of company A be supplemented by a balance-sheet of its subsidiary, the parent company's investment in its subsidiary being specifically so described, B's investment in company A being identified by description in like manner.

The alternative outlined is, we may say, permissive rather than desirable.

Dealing with the further question, it would be improper to include the investment in the subsidiary in the item described as "stocks and bonds of other companies." Such investment should appear as a separate item properly described. Of course, this question does not arise if the accounts are consolidated.

Answer No. 2: We favor showing the situation as follows:

Investment in shares (cost) of wholly owned subsidiary	
which in turn owns shares of blank com-	
pany	\$—————

FREIGHT, ROYALTIES, PACKING AND SHIPPING AS EXPENSES

Question: The question of the correct treatment of certain expenses has come up in connection with my practice and I should greatly appreciate any assistance you can give me in the matter.

The first question is the proper allocation of the cost of freight outward. I have deducted this cost from gross sales but I notice that a number of ac-

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countants consider this as a selling expense. Could you advise me the best practice with respect to the allocation of this expense?

Another matter is the question of the proper allocation of royalties paid. In this case a corporation manufactures candy and pays royalties to another corporation for the use of a name which is trade-marked, and the royalties are paid on the number of cartons sold. I have treated the cost of royalties as a selling expense but the corporation for whom I do the work wishes me to regard this expense as a deduction from gross sales. In your opinion, which is the correct allocation of this expense?

Another matter which has come up is the proper treatment of packing and shipping supplies and packing and shipping labor. I have treated these items as a selling expense but the management of the corporation believes that these expenses should be regarded as manufacturing costs. I have held that these items should be allocated to selling expenses.

The corporation maintains certain branch offices in the West from which offices sales are made to customers in adjacent territories. I believe that all the expenses of these branch offices, including the office salaries, postage and office expenses, are correctly allocated as a selling expense. Will you please advise me if you consider this a proper allocation?

Answer No. 1: The first question refers to the proper allocation of cost of freight outward. We believe that the correct procedure is to deduct such freight from the proceeds of sale rather than to consider it as a selling expense because, as a matter of fact, it is not a selling expense.

The second question has to do with royalty payments. The logical thing in this case is to charge the royalties paid to cost of sales and not as a selling expense because it is, in fact, an expenditure for the privilege of making and selling its product and not part of the expenses incurred in selling.

The third question has to do with packing and shipping supplies and packing and shipping labor. These expenses are also part of the cost of sales; they are neither manufacturing cost nor selling expense.

The fourth question refers to the expenses of a branch office. Inasmuch as the branch office is established and maintained for the purpose of selling, this expense may logically be included among selling expenses.

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